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Politics this week

Sep 18th 2003
From The Economist print edition

Permanent removal?

AFP

The Israeli cabinet took a decision to "remove" **Yasser Arafat**, though it did not specify how or when. The Americans vetoed a Security Council resolution deploring this, but lent on Israel in private not to carry out its threat.

See article: If Arafat goes?

The Bush administration accused **Syria** of backing terrorists, harming American interests in Iraq and developing dangerous weapons. The Syrians, who have provided key intelligence on al-Qaeda, said they would like to co-operate, but that America is biased towards Israel and its demands are unreasonable.

See article: Selling the occupation

The UN Security Council lifted the 11-year-old (currently suspended) sanctions against **Libya**, formally ending a ban on arms sales and flights imposed after the Libyans were implicated in the 1988 bombing of a Pan Am flight over Lockerbie, in Scotland. America and France abstained.

The International Atomic Energy Agency gave **Iran** until October 31st to come clean and disprove suspicions about its nuclear programme.

See article: Iran's nuclear programme

Around 300 Moroccan schools began to teach Tamazight, the **Berber** language which predates Arabic in north Africa. Education officials say it will be available in all schools by 2008, in a move that represents victory for Berber-rights activists, but a problem for schoolchildren who will have to cope with Arabic, Latin and Berber scripts.

Results from **Morocco's** local elections confirmed that the Islamist PJD would have led in Casablanca, the country's largest city, if it had not voluntarily restricted the districts where it presented candidates.

The army staged a coup in **Guinea-Bissau**, overthrowing President Kumba Yala. The country's new military leader is General Verissimo Correia Seabra.

See article: Popular coup in Guinea-Bissau

Zimbabwe's only privately owned daily paper, the *Daily News*, was shut down.

See article: Zimbabwe's continuing descent

Whitehouse Clark?

Wesley Clark, speaking in his hometown of Little Rock, Arkansas, announced that he would seek the Democratic nomination for president. Mr Clark, a former supreme commander of NATO, is the tenth hopeful to enter the race for the White House.

See article: Wesley Clark enters the race

California's recall ballot, scheduled for October 7th, was postponed. A court ruled that the poll would not allow for equal treatment of votes—almost half the electorate would use the punch-card technology that disrupted the previous presidential election.

See article: Curse of the hanging chads

Frank O'Bannon, **Indiana's** Democratic governor, died aged 73 after suffering a stroke. His deputy, Joe Kernan, was officially sworn in as governor until next year's election.

As **Hurricane Isabel** headed towards the eastern seaboard more than 100,000 people left their homes.

See article: The lady's not for turning

AP

Johnny Cash, one of country music's most enduring stars, died aged 71. The “man in black” was laid to rest at a private ceremony in Hendersonville, Tennessee.

Off the tourist trail

Eight foreign tourists were kidnapped by gunmen in the northern jungles of **Colombia**. The Colombian government blamed the leftist FARC guerrillas; the FARC denied it, saying the abduction was carried out by men in military intelligence.

See article: Child combatants in Colombia

Venezuela's election board, which had been edging closer to the government, turned down a petition for a recall referendum against President Hugo Chávez. The petition's organisers immediately started to gather more than 3m signatures all over again.

See article: Venezuela's referendum saga

Keeping the krona

Getty Images

Swedish voters rejected a proposal to adopt Europe's single currency, the euro, by a margin of 14 percentage points, despite an expected late swing in favour, following the murder of their pro-euro foreign minister, Anna Lindh, on the eve of the referendum. A Swede was arrested in connection with the murder.

See article: Sweden's euro referendum

Estonians, also in a referendum, said they wanted to join the European Union, by a margin of two to one.

See article: The Balts vote on joining the European Union

The leaders of **Germany, Britain** and **France** prepared to meet in Berlin for their first three-way session in two years, to discuss ways of overcoming Europe's differences and breaking the deadlock over a UN resolution on Iraq.

The head of the European Commission, **Romano Prodi**, presented a plan to streamline decision-making, by allowing, for instance, seven senior commissioners to take collective decisions, rather than insisting that the whole college of commissioners should give its assent. The plan has in mind the expansion of the Union from 15 to 25 members next year.

Silvio Berlusconi, Italy's prime minister, unveiled a plan for constitutional reform which would—among other things—slim down parliament, shift more power from president to prime minister, and give more say to the regions. In a separate development, he apologised to Jews for saying recently that Mussolini,

Italy's fascist dictator, had “never killed anyone”.

See article: Can Italy's government impose reform?

Possibly militant; may be dead

Police in Indian-controlled **Kashmir** reportedly killed Nasir Mehmood Ahwan, allegedly the deputy leader of Jaish-e-Mohammad, a militant group. Ghazi Baba, the group's leader, was recently killed by Indian paramilitaries. Since Mr Baba's death, violence in the state has escalated, leaving more than 200 people dead.

At least 120 people were dead or missing after the most powerful typhoon ever to hit **South Korea**. The government is to give 1.4 trillion won ($1.2 billion) in disaster relief.

South Korea's home-affairs minister, Kim Doo-gwan, quit after opposition politicians accused him of failing to stop a demonstration at an American military base in August.

The Chinese government was said to have transferred control of its border with **North Korea** from the police to the People's Liberation Army. Australia and three other nations conducted a joint maritime exercise in the Coral Sea aimed at stopping and boarding vessels suspected of carrying cargoes connected with weapons of mass destruction. Although not the only one, North Korea could be a target of such action.

See article: China and North Korea

Ali Imron, a 33-year-old teacher, was convicted of planning last year's **Bali** bomb. He was sentenced to life imprisonment.

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Business this week

Sep 18th 2003
From The Economist print edition

Collapse in Cancún

A meeting of the **World Trade Organisation** in Cancún, Mexico, broke up amid acrimony. Representatives of the world's poorest nations blamed rich countries for making too few concessions on agricultural subsidies and for insisting on new rules on investment.

See article: The WTO under fire

Grasso goes

A barrage of criticism forced **Richard Grasso** to resign as chairman of the New York Stock Exchange. The resignation came after an emergency meeting of the **NYSE**'s board, which had become alarmed at the ever-growing controversy over Mr Grasso's $188m pay package.

See article: Richard Grasso resigns

Ahold responded to the disquiet of shareholders over a recent accounting scandal and fat-cat salaries. The Dutch retailer said that the head of its supervisory board would quit—investors hold him responsible for the hole in the firm's accounts and the over-generous pay of its chief executive, who was duly given a cut.

The SEC asked a judge to block a severance payment of *euro*21m ($23.5m) to **Jean-Marie Messier**, former boss of Vivendi Universal, a couple of days after an American court had ordered Vivendi to make the payment. The regulator is investigating the media giant. Shareholders had tried, unsuccessfully to stop payment on the grounds that Mr Messier had brought the firm close to ruin.

Can do attitude

Alcan, a Canadian aluminium firm, had its latest offer of *euro*4 billion ($4.5 billion) accepted by **Pechiney**, a French rival. The European Commission, which struck down a similar deal in 2000, is yet to approve the takeover and may demand asset sales if it does.

Microsoft, until recent years famous for never paying a dividend, chose to double its annual payout to investors and hand over $1.7 billion. The software giant will still hold on to the bulk of its cash reserves of some $48 billion to guard against adverse legal judgments; cases outstanding include a lawsuit from Sun Microsystems and the threat of an antitrust case from the European Union.

In acknowledgment of the ills besetting the industry, the United Auto Workers union acted quickly to complete contract negotiations with **Detroit's Big Three car companies** and two of the industry's largest parts suppliers.

See article: Pay deals in Detroit

Voters in **Seattle** rejected a proposal to levy a coffee tax of 10 cents a cup to pay for pre-school education. Café owners celebrated with something stronger than a skinny latte.

Formation flying

KLM Royal Dutch was on the verge of joining **Air France** in the SkyTeam alliance (with Italy's Alitalia and America's Delta Air Lines). Observers speculated that this would eventually lead to a full merger of Europe's fourth- and second-largest airlines. Loss-making KLM has previously attempted to merge with British Airways.

See article: Reshaping the airline industry

The European Union's competition watchdog opened a formal investigation into the French government's plans to give aid totalling *euro*3.2 billion ($3.6 billion) to **Alstom**, an ailing engineering firm, and may order France to suspend aid.

No smoke without firing

R.J. Reynolds stubbed out 2,600 jobs, some 40% of its workforce. The struggling American cigarette company blamed competition from low-cost brands.

In a deal with America's Justice Department, **Merrill Lynch** said that it accepts responsibility for alleged criminal acts by some of its employees in the Enron affair. The same day, three former Merrill Lynch executives were charged.

Eliot Spitzer's investigation into the American mutual-fund industry yielded its first criminal charges. New York's attorney-general filed charges against a former broker at Bank of America. The SEC followed up with civil charges.

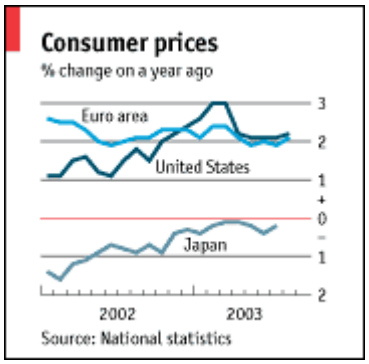
Eurex, a German-Swiss derivatives exchange, unveiled plans to set up a new, all-electronic market in Chicago next year. It will be the first foreign exchange in America and a direct challenge to the Chicago Mercantile Exchange and the Chicago Board of Trade.

See article: A European assault on America

A Chinese court barred a Shanghai entrepreneur from using the word "**capitalist**" as part of the name of his company. It could "produce negative results and misguide the public", said the court.

Rising prices

Consumer prices in America rose by 0.3% in August and by 2.2% over the year. The Federal Reserve signalled that it would keep interest rates low for a while yet to boost employment and hasten economic recovery. Inflation in the euro area was confirmed at a five-month high of 2.1%, again breaching the European Central Bank's 2% ceiling.



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World trade talks

Cancún's charming outcome

Sep 18th 2003
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Champions of the world's poor are celebrating the collapse of global trade talks. Some champions

"VICTORY to the people," cheered a press release from a globophobic activist group, Food First, after the world trade talks broke down in Cancún on September 14th. This delight is widely shared among developing-country advocates and even among many poor-country governments. Great news from Cancún? What scandalous rubbish. The failure sprang not from principle, nor even from intelligent calculation, but from cynicism, delusion and incompetence. It is going to leave most people in the world worse off—and, without a doubt, those who will suffer worst are the world's poor.

At the very least, Cancún's failure has delayed progress towards concluding a trade round that would have given poor countries the biggest economic gains. Launched in the Qatari capital, Doha, in November 2001, the Doha trade round was explicitly dedicated to helping poor countries. Its chief goal was to lower trade barriers in areas where freer trade would help poor countries most, especially agriculture. With the Doha round in tatters, the day when rich countries repeal their grotesque farm subsidies and poor countries can finally sell textiles to the rich world without facing punitive tariffs has been pushed far into the future. The chances of concluding the round by the original deadline of December 31st 2004 are now nil. To finish it within five years would be difficult.

As if this were not bad enough, the breakdown in Mexico may have dealt a mortal blow to the multilateral trading system itself—a system that, for more than half a century, has underpinned global prosperity. Since the General Agreement on Tariffs and Trade was signed in 1947, with its basic principle that tariffs must not discriminate between countries, trade has been governed by multilateral rules. The World Trade Organisation, created in 1995 as a successor to the GATT, is the system's core. With 148 members (Cambodia and Nepal joined just days ago), the WTO is the only trade forum in which the needs of the developing countries can be given full weight. Decisions there are reached by consensus; every country, no matter how small or poor, has a veto. Nowhere else do poor countries have such clout.

Cancún's collapse leaves the whole system in peril. It comes less than four years after a similar flop in Seattle in 1999, where efforts to launch trade talks failed amidst street violence. After two such abject defeats in four years, the WTO is in enormous trouble. If it becomes entirely irrelevant to the conduct of trade policy—as it may, and as many governments and activists seem to desire—the developing world will come to regret the consequences bitterly over the coming years.

Who to blame

The breakdown was entirely unnecessary. Trade ministers were not trying to come to a final agreement on the Doha round; they were not even making difficult choices about exactly how far to open their economies. The purpose of Cancún was far more limited: to be no more than a mid-course stock-taking, a time to agree on principles for taking negotiations forward. It is extraordinary, and all the more shameful, that the ministers failed even to do this.

All concerned are pointing the finger, as one might say, at each other. In fact, nearly everybody involved deserves criticism (see article). For all the fine promises made at Doha, rich countries could see no farther than the interests of their own farmers. America's unwillingness to curb its cotton subsidies—

which have an especially severe effect on poor-country producers—is unforgivable. So too is Japan's unyielding defence of its own swaddled rice farmers. And for all its ballyhooed efforts at reform, the European Union remains the most egregious farm subsidiser of all. Europe deserves added blame for trying to push poor countries into negotiating new rules on investment, competition, government procurement and trade facilitation, when most of them clearly did not want to.

Yet the rich countries did not wreck Cancún by themselves. Many poor countries saw the Doha round, and its promise to be pro-poor, as an excuse for making demands of the rich world while doing nothing to lower their own trade barriers. They forgot that trade talks require compromise. Egged on by a bevy of activists, too many third-world politicians got carried away by the thrill of saying no—ignoring the fact that poor countries actually have more to gain from lowering their own trade barriers than from persuading rich countries to lower theirs. According to the World Bank, over 70% of the benefits that poor countries might see from the Doha round would come from freeing trade with each other. By refusing to compromise, poor countries have come away with nothing.

Heading for a fractured world

Optimists, of whom there are still a few, point out that previous trade rounds have all taken longer than scheduled to complete. The Uruguay round took eight years rather than the planned three. Maybe the Doha round can be revived after all.

If so, the prospect looks remote. A presidential election is looming in America: starving peasants are not a pressing constituency. The European Union, with ten new members to absorb, is also going to be distracted. In any case, the energies of rich-country trade negotiators can always be deployed in a different—and, as they would see it, more effective—direction. Bilateral and regional trade agreements are already in favour with the Bush administration. In this setting, the poor countries have far less sway than they would have at the WTO; that is why American legislators prefer such deals. America is pursuing a regional trade agreement for the Americas, has signed bilateral deals with Chile and Singapore, has begun bilateral talks with 14 other countries, and promises many more.

This way lies a fracturing of the global trading system. Adding to the danger is growing protectionist sentiment in the United States. For the past decade, America has been the main engine of global growth: its trade deficit and its debts to foreigners have therefore been soaring (see our survey of the world economy). Trade deficits, particularly when jobs are scarce, increase demands for protection.

China, with its huge and growing bilateral trade surplus with America, has already been cast as chief villain. With a cheap currency, the argument goes, China is stealing American jobs. Once this scapegoating starts, protectionism follows close behind. Last week, senators from both parties introduced a bill that would put high tariffs on imports from China unless China adjusts its exchange rate. This particular measure will probably fail, but there will be others. In the mid-1980s, when America last had a huge trade deficit, demands for new protection (mainly against Japan) proved impossible to resist.

The collapse of the global trade talks may itself worsen the backlash. The prospect of a global trade round helped curb calls for new protection, making them seem disreputable; if there is to be no round, there will be less holding back. An American government concentrating on bilateral trade deals and domestic politics bodes ill for the global economy. And the idea that the EU might exercise enlightened leadership while America is thus distracted is, unfortunately, laughable.

The humbling of the WTO not only worsens economic prospects for the developing countries (as well as for the rest of the world) but also shifts the balance of global political power from poor to rich—perhaps decisively, and who knows for how many years. That is what the developing countries' champions are so busy celebrating.

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Sweden and the euro

Voters can be such a nuisance

Sep 18th 2003
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Will Europe's leaders ever start listening to their citizens?

Get article background

PA

IN THE end, Sweden's voters rejected their government's plan to adopt the euro by a surprising margin. Although the government of Goran Persson was itself divided on the issue, the weight of opinion across the main political parties, the business press and other media had been overwhelmingly in favour. The yes campaign was many times better financed than the comparatively invisible no campaign. And just days before the vote, Anna Lindh, Sweden's appealing foreign minister and spokesman for the yes campaign, was stabbed to death, arousing outrage that seemed likely to draw votes to her side. Yet Sweden voted no by 56% to 42%: under the circumstances, a crushing defeat for the pro-euro alliance.

Whether Sweden has made the right decision is debatable. From an economic point of view, there are things to be said on both sides. In some ways, Sweden is the ideal euro candidate: a small, open and internationally competitive economy, with more than most to gain from exchange-rate stability across Europe. On the other hand, the euro area is performing badly, partly because its economic-policy rules have been poorly designed, whereas Sweden is doing well. A vote to wait and see, if that is what it was, makes sense. Sweden can adopt the euro later, if it seems to be losing inward investment, or if the policy rules are mended, or if the euro area's performance inspires. In this, no is not for ever. Yes is—or that is the idea, anyway.

In fact, however, Sweden appears not to have been voting to wait and see. Arguably, the country was not even voting about the euro, as such (see article). So far as one can tell, the vote reflects a verdict on the economics of the single currency less than it expresses deeper suspicions about what the European project implies for Sweden's sovereignty and for the future of its democracy. This matters for Europe as a whole, not just Sweden, because people in many other countries have similar doubts—and because many of them, just like the Swedes, will shortly get a chance to say so.

Next month the European Union embarks on an inter-governmental conference (IGC) whose task is to finalise the proposed new European constitution. We have already said what we think of the draft constitution produced by Valéry Giscard d'Estaing's convention—we think it fit for the dustbin—but we will leave further denunciations for another time. The point is that the new constitution, once it emerges from the IGC, will need to be ratified by every government in the Union. In several countries, it is already understood that ratification will be subject to referendum. Pressure for a referendum is mounting elsewhere too—notably in Britain, whose government has pledged to deny a vote to its citizens, despite the fact that more than 80% of voters say they want one.

How many Swedens?

As widely noted, Sweden's rejection of the euro will sustain anti-euro opinion in Denmark and Britain (the union's other non-euro members) and makes it unlikely that any of the three will soon fall into line: the EU will therefore remain a multi-currency area for the foreseeable future. That is significant, but far more important is the fact that forthcoming referendums on the constitution now seem increasingly unlikely to go as governments would wish. It will take only one Sweden to block plans for a new constitution, and

two or three might kill them.

“When we ask voters a European question, the answer is either no, or yes by only the narrowest of margins,” the *Financial Times* quoted an official of the European Commission as saying this week. “That should be telling us something,” he added. This penetrating insight deserves applause. It should indeed be telling them something. Mainly, it should be telling them that the “ever closer union” envisaged by the proposed constitution does not seem to be what most Europeans want.

It is true that Europe needs new rules if the EU is to function at all after the admission of ten new members, with more to follow. Procedures will have to be simplified. But in revising the rules to this end, it is vital to define and protect the powers of the sovereign countries that make up the group—and to do so in a way that voters understand. On present plans the new constitution not merely fails in this, it seeks to blur and erode national powers still further. Hitherto, Europe's leaders have made it their specialty blithely to ignore popular doubts about their European vision. Few of them seem ready to try a different approach. They should look at Sweden, think about the obstacles between here and ratification of a new constitution, and get to work at next month's meeting on plan B.

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Executive pay

Taking stock of Dick Grasso

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From The Economist print edition

What, exactly, did the resigning chairman of the New York Stock Exchange do wrong?

Get article background

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GONE are the days when Richard Grasso was the proud face of America's stockmarket-based model of capitalism. The ubiquitous chairman of the New York Stock Exchange (NYSE) became a familiar figure, ringing the exchange's bell on TV and, along with New York's then mayor Rudy Giuliani, counted as one of the city's heroes after September 11th. Admirers dubbed him the "president of capitalism".

No longer. In the past few weeks, Mr Grasso has been ticked off by the Securities and Exchange Commission (SEC), America's market regulator; lambasted by America's biggest public pension funds; and criticised by a growing band of NYSE members. Now, finally, he has resigned (see article). But what, exactly, did Mr Grasso do wrong—other than become very rich, surely *de rigueur* for the president of capitalism? Mr Grasso's sudden unpopularity was due entirely to the $188m in accrued pay and benefits provided to him this year. Unfortunately, this payout inspired much self-righteous humbug.

Consider the case for the defence. Mr Grasso's pay, though huge, was in line with many of America's top bosses. Yes, the governance of the NYSE does not meet the high standards which the exchange now imposes on listed companies. But the NYSE is a private firm: these are not usually subject to rules imposed on public firms. Does anybody really think that the fat cats on the NYSE board were shocked (shocked!) that Mr Grasso was so well paid? Unlikely. They gave him the money.

Nor is the NYSE a mere utility or regulator, which should not pay its boss an entrepreneur's salary. Mr Grasso saw that the NYSE was in a competitive battle—against the Nasdaq market, new electronic exchanges and foreign stockmarkets—and he took the right action from his exchange's point of view. He built the NYSE into a leading global brand, not least by stressing the integrity of the exchange and making a decent fist of its regulatory role. And he fended off regulatory changes which would have opened the NYSE to more competition.

Ah, there's the rub. The real culprit in this tale is not Mr Grasso, nor the group of greedy NYSE members who filled his pockets, but the SEC, whose job it is to ensure the best possible deal for investors, and the right amount of competition between stockmarkets. The truth is that Mr Grasso's reputation was always overblown. The initial public offerings that he helped to make so popular with small investors were never a good deal for most of them. And he refused to abandon floor trading in favour of electronic trading. That would have benefited investors at the expense of his members' profits by opening the NYSE to more competition. But, then again, defending the profits of his members was his primary task.

If Mr Grasso's inflated reputation enabled him to dissuade the SEC from doing the right thing, the commission should now take the opportunity afforded by the furore and his resignation to launch a sweeping reform of how the NYSE itself is run and regulated. The SEC should take away the NYSE's regulatory role, as has already happened with Nasdaq's, and force the creation of a level playing field between electronic exchanges and the NYSE floor traders. Investors deserve a better deal. Why did anyone ever believe that Mr Grasso, of all people, would give them one?

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Israel and the Palestinians

Killing Arafat is wrong

Sep 18th 2003
From The Economist print edition

George Bush is stopping Ariel Sharon from "removing" Yasser Arafat. For how long?

AP

Get article background

HE IS a pesky, devious autocrat, as incompetent at administration as he is at negotiation, an acknowledged problem even for his colleagues. But, awkward as he is, Yasser Arafat is the Palestinians' elected president, the symbol of the identity that they have preserved through years of tribulation. Moreover, no evidence has been produced, though there is bad-mouthing in plenty, to connect him with the terrorist bombs that have killed so many Israeli civilians. Yet the Israeli government decided on September 11th that he should be "removed", possibly, as Israel's deputy prime minister, Ehud Olmert, later expounded, by assassination. Politically, this decision was unwise; morally and legally it is indefensible.

Mr Olmert, ruminating on killing Mr Arafat, was playing to a narrow domestic gallery. In its demonising of the Palestinian leader, the government has Israeli public opinion full-throatedly behind it. Ever since the collapse of talks at Camp David three years ago, and the start of the Palestinians' armed *intifada*, Mr Arafat has been depicted by Israelis, government and people, as the source of all evil. Mr Olmert's colleagues, realising that talk of killing was hardly tactful, have played his statement down. But, in fact, Mr Olmert may have been calling a spade a spade: expulsion and killing could be synonymous. When Mr Arafat declares that he will never again be driven into exile, but will greet soldiers who come to arrest him pistol in hand, most Palestinians believe he is telling the truth.

Regime-change has been much in the air since the September 11th terrorist attacks in America, but Israel has not made its case for removing Mr Arafat. Though he continues to struggle against the Israeli occupation, he has not, for a long time, been a "terrorist" in internationally accepted uses of the term. Even if he were, it would almost certainly be unwise to expel or kill him, turning him into a political martyr. As it is, it is unacceptable, by any standard, for a government to announce that it intends to remove the elected head of a nation-to-be that it is supposed to be negotiating with over independence.

Under American orders

Does the Israeli government care? Not on any general principles. It is not, as yet, implementing its decision because the United States has told it not to. Although George Bush's administration refuses to have any dealings with Mr Arafat, and would clearly like to see the back of him, it is aware of the political consequences if Israel goes beyond isolating the Palestinian in his Ramallah headquarters, and proceeds somehow to remove him. Its public reaction to the Israeli cabinet decision was muted: Colin Powell, the secretary of state, and Condoleezza Rice, the national security adviser, described it as not helpful; after Mr Olmert's clarification, Mr Powell, from Baghdad, spoke of the danger of Arab outrage. But, in private, Mr Bush has issued clear instructions to Ariel Sharon to leave the Palestinian president alone (see article).

The question is what happens after the next big terrorist outrage. Even with America's current prohibition, the situation remains dangerous. Mr Sharon's office had been letting it be known that it had detected some weakening of America's opposition. This could have been misinformation, preparing the way for action, in which Mr Sharon would claim, not for the first time, that Israel had been given at least an amber light to proceed. And, indeed, this sequence could still happen, leading to unpredictable

mayhem in the occupied territories, and possibly ending the era of Palestinian self-rule.

Mr Sharon likes to look wise, these days, restraining his colleagues. But in the past, the old warrior has acted on bad impulse. Though he has agreed to a Palestinian “state”, he remains profoundly opposed to the state based on pre-1967 frontiers that Mr Arafat stands for. Thus, for reasons that have little to do with terrorism, he is determined never to get into negotiations with the Palestinian. This is a core difference between the two: Mr Arafat blew his chances at the Camp David talks, but Mr Sharon would have avoided starting them.

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Californian politics

The tragicomedy continues

Sep 18th 2003
From The Economist print edition

Delaying the recall election is even madder than having one in the first place

Reuters

WHEN George Bush climbs into his pulpit to preach the wonders of democracy, insolent foreigners have been wont to whisper words like “Florida” and “recount”. Now add the words, “California” and “recall”. To paraphrase Wilde's Lady Bracknell, the hanging chads in Florida looked unfortunate; the fact that, three years later, America cannot run a decent election in its richest state looks downright careless.

Last year, Governor Gray Davis, a fairly incompetent Democrat, was re-elected by the Golden State. This summer, with little having changed in the case of either Mr Davis or the hapless state, enough voters signed a petition to force a vote on whether to recall (ie, sack) Mr Davis on October 7th. The recall vote comes in two parts. If Mr Davis loses the first bit (as he would do with anything less than 50% of the vote) he will be replaced by whoever, out of some 135 candidates, gets the most votes in the second part (no matter how small the proportion). This is the contest Arnold Schwarzenegger, an Austrian-born exponent of what Lady Bracknell would have called moving pictures, has entered.

This already strange procedure has now taken another twist. This week a panel of three Democratically-appointed judges from the often eccentric federal 9th Circuit Court of Appeals, overruling an earlier decision by a Republican-appointed judge, decided that the recall should be delayed till March 2nd, a date that, as it happens, should be more helpful to Mr Davis (see article). The whole 9th Circuit Court will now review this decision. If it backs the panel, Mr Davis's foes will try to get the Supreme Court, where there is a majority of Republican-appointed judges, to intervene. Sound familiar?

On closer inspection, there are plenty of grounds to condemn America's voting system, but surely not enough to delay this election. Judges, particularly politically appointed ones, and electioneering do not mix well. The barrier for the courts to justify interfering in an election should be fairly high; in this case, it has not been cleared.

The three-man panel's decision is based on the fact that 44% of the likely voters will have to use the old punch-card voting machines. These voters, from urban counties like Los Angeles and San Diego, will be disproportionately black and Latino, so minorities are said to be discriminated against. Altogether, they reckon that some 40,000 people may lose out because of the technology.

This sounds a lot, but it needs to be set in context. No recent Californian gubernatorial election has turned on such a small margin. Moreover, some 375,000 Californians have already sent in absentee ballots—which may now be invalid. The same balloting system was used for Mr Davis's re-election last year, with no complaints from anyone. It seems distinctly rum for organisations like the American Civil Liberties Union, which seems increasingly to have forsaken principle for partisan politics, to suddenly start crying foul for fear that the Democrat is more likely to lose. A delay now is not a politically neutral technicality: it changes the whole character of the race in mid-election and plainly favours one candidate, Mr Davis.

So let the recall election go ahead as planned—and, in the unlikely event the vote comes down to a few thousand votes, let the losers try their luck with the courts. But the main lesson for America should be the urgent need to update its voting technology. California is only one of many states not to have learnt the lesson from Florida: 25 other states still use the old punch-card system. If America wants to keep the

courts out of elections—and heaven knows, that is a good idea—then it should speed up the process of modernisation. Otherwise, the sniggers when it talks about democracy will get louder.

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Letters

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From Economist.com

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Allende remembered

SIR – You say that President Salvador Allende's "nationalisation and collectivisation brought economic disaster" to Chile ("That other September 11th", September 6th) and that by 1973 "a majority of Chileans probably favoured his overthrow" ("Memories of a coup", September 6th). You note that "American officials encouraged the coup" but claim their role was "not decisive". Others will beg to differ.

As a Senate report revealed in 1975, the United States increased its military aid to Chile before the coup and stepped up its training of Chilean military personnel in Panama. Meanwhile, the CIA was under orders from President Richard Nixon to "make the economy scream". Edward Korry, America's ambassador to Chile at the time, said that "once Allende comes to power we shall do all within our power to condemn Chile and all Chileans to utmost deprivation and poverty."

Perhaps this is the "cold-war climate" that you mention. But some may believe that it suits you to give the impression that socialism was to blame for the "economic disaster" and the purported turnaround of Chilean opinion, rather than American policies. On the other hand, perhaps the hardships imposed on the Chilean population were "not decisive" in the success of the coup.

Jean-Philippe Marcotte
San Francisco

SIR – While nothing can excuse the human-rights abuses committed by the Chilean military, Allende and his supporters were far from the peace-loving dreamers that you like to imagine. Allende won an election with only 36% of the vote and then embarked on a course of action for which he lacked any democratic mandate. This ushered in a period of total economic collapse.

His political mistake was not then "to force change more quickly than many Chileans could stomach" but rather to remove the possibility that his government would ever cede power through the ballot box. With moves by the communists to arm workers and their seeming control over Allende, it was hardly surprising that the majority of Chileans greeted the coup with rejoicing. Indeed, Patricio Aylwin, the first elected president after General Augusto Pinochet, welcomed the army's intervention at the time as a move to restore democracy. Mr Aylwin was to be sorely disappointed by what followed but Allende's canonisation by the left as a peace-loving "democratic revolutionary" is totally without foundation.

Nicholas Allan
London

Doing a drug deal

SIR – You understandably welcome the apparent resolution of the issue of drug access in the developing world ("Symptomatic relief", September 6th). However, when one looks at the proposed deal the question arises of how the drug industry reached such a solution given its likely impact on the development of drugs, the almost universal doubts about its workability and its impact on shareholder value.

The refusal of senior management to take the issue seriously has meant that its ramifications on markets in Europe and North America have hardly been noticed let alone analysed. However, such work as is

being done shows that the proposed system is likely to be profoundly damaging to the industry position on a wide variety of other issues.

How might this issue have been dealt with if, instead of defending a politically untenable status quo, the industry had proposed a system that would have achieved the professed desired outcome more efficiently: a system that did not tacitly accept responsibility way beyond that of any other sector and that enhanced shareholder value. It is probable that such a move might have prevented the rolling of the pressure-group and media bandwagon that is undermining the industry, not simply on the issue of healthcare in sub-Saharan Africa but in crucial first-world markets.

Simon Bryceson
London

Putting the Boot in

SIR – Charlemagne writes that “Some of the American neo-conservatives who were bashing both France and the United Nations earlier this year have markedly changed their tune” (September 6th). As evidence he cites two lines that I penned in February. In the *Times* I wrote that “Normally no one in his right mind would look to France for anything more weighty than a good soufflé recipe,” and in the *Financial Times* that, while the UN “provides a useful forum for palaver...as an effective police force it is a joke.”

I stand by both statements, which I do not find in any way incompatible with my recent advocacy, in the *New York Times*, of the administration's seeking another UN resolution on Iraq. I still believe it is a mistake to let France set the agenda for American action—or, more often, inaction. Tony Blair and George Bush were right to ignore Jacques Chirac's grandstanding and liberate Iraq anyway.

I also continue to believe that the UN cannot be an effective police force. In fact the UN recognises this itself. It is not asking to send blue helmets into Iraq. Everyone agrees that even if another UN resolution is passed, America would still have to play the leading military role in Iraq. Under those circumstances (akin to the Korean or Gulf wars), getting another UN mandate is in America's interest—not because the UN itself will be policing Iraq, but because this will provide a fig-leaf that may allow other states to contribute troops and, more important, funds.

I hope that Mr Chirac and Dominique de Villepin will allow this to happen by playing a more constructive role in the UN today than they did before the war in Iraq. Perhaps by now they have realised that winning the war on terrorism is more important than enhancing battered French esteem at the expense of the “hyperpower”.

Max Boot
Council on Foreign Relations
New York

Poor relations

SIR – You say that America's inequalities stand out only in so far as the rich are richer than in other countries while the poor are about as badly off as the poverty-stricken of more socially minded countries like Sweden (“Would you like your class war shaken or stirred, sir?”, September 6th). But look at it this way: would you rather have your car break down in a poor neighbourhood of Los Angeles or Stockholm? Detroit or Oslo?

The American neighbourhood is worse off than its western counterparts because of drugs, crime and racial problems. It is not only the rich that make America unequal; it is also the quality of life of its poor.

Neal Colgrass
Los Angeles

SIR – Politicians on the left in America like to trumpet the income spread between the average worker and the average chief executive as proof positive of class war in America. I wonder if these politicians would like to divulge their personal wealth (not excluding the perks of office) so that we can measure the inequality that exists between the average worker and the average senator or congressman. The great American class war is that between the political class and the productive class.

Peter Saint-Andre
Denver

Repeating history?

SIR - In your "Selling the occupation" (September 15th), you report: "As he toured Iraq, Colin Powell insisted American forces were not occupiers but liberators." Nothing new here. It is a leaf taken from old colonial powers. In 1921, Lieutenant-General Sir Stanley Maude said in Baghdad: "Our armies do not come as conquerors but as liberators." Within three years, 10,000 had died in an uprising against the British, who gassed and bombed the "terrorists".

Waguih Draz
La Mulatiére, France

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The Doha round

The WTO under fire

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From The Economist print edition

EPA

Why did the world trade talks in Mexico fall apart? And who is to blame?

SOME poor countries' politicians seemed to revel in the collapse of the World Trade Organisation's ministerial meeting on September 14th. The Philippine trade minister, for instance, told Reuters news agency that he was “elated” by it. Tanzania's delegate claimed to be “very happy” that poor countries had stood up to rich-country “manipulation”. But others were upset and shocked. According to one observer, the trade minister of Bangladesh had tears in his eyes. “I'm really disappointed,” he is reported to have said. “This is the worst thing we poor countries could have done to ourselves.”

Disappointment is the right reaction. For the Doha round of trade talks run by the WTO was geared specifically to help poor countries. They will be the biggest victims if the talks cannot be revived, and there seems to be scant prospect of that. The negotiations have not been officially abandoned. Diplomats pledged to continue talking in Geneva, the WTO's headquarters, with a formal meeting to be held no later than December 15th. But momentum has clearly been lost. No one now expects the round to finish by its original deadline of December 31st 2004. Some trade officials privately wonder whether it will ever finish, or whether Cancún's collapse—coming less than four years after the Seattle ministerial meeting broke down in December 1999—marks the end of the WTO as an effective negotiating forum.

The price of posturing

According to the World Bank, a successful Doha round could raise global income by more than $500 billion a year by 2015. Over 60% of that gain would go to poor countries, helping to pull 144m people out of poverty. While most of the poor countries' gains would come from freer trade among themselves, the reduction of rich-country farm subsidies and more open markets in the north would also help. That prize is now forgone.

As the scale of this lost opportunity becomes clear, the post-mortems and recriminations are beginning. Three big questions stand out: Why did the talks collapse? Who was to blame? And where does the WTO go from here?

Though the speed of the collapse caught even seasoned trade negotiators by surprise, the seeds of disaster were sown long before September 14th. The launch of the Doha round in the eponymous capital

of Qatar in November 2001 was itself a nail-biting negotiation marked by acrimony between rich and poor. The rhetoric was grand: Doha would reduce trade-distorting farm support, slash tariffs on farm goods and eliminate agricultural-export subsidies; it would cut industrial tariffs, especially in areas that poor countries cared about, such as textiles; it would free up trade in services; and it would negotiate global rules (subject to a framework to be decided at Cancún) in four new areas—in competition; investment; transparency in government procurement; and trade facilitation. These four new areas are referred to as the "Singapore issues" after the trade meeting at which they were first raised.

From the start, countries disowned big parts of the Doha agenda. The European Union, for instance, denied it had ever promised to get rid of export subsidies. Led by India, many poor countries denied that they ever signed up for talks on new rules. Other poor countries spent more time moaning about their grievances over earlier trade rounds than they did in negotiating the new one. Several rich countries too showed little interest in compromise. Japan, for instance, seemed content simply to say no to any cuts in rice tariffs.

This kind of posturing meant the trade round stagnated for 22 months between the meetings in Doha and Cancún. All self-imposed deadlines were missed; all tough political decisions were put off. That placed a needlessly heavy burden on the Cancún meeting. But it was not an overloaded agenda that killed the talks last weekend. It was that too many countries continued grandstanding at the Mexican resort, rather than seeking the compromises on which trade talks depend.

Focus on farming

Agriculture was the toughest issue dividing negotiators both before and during the Cancún meeting. After months of stalemate, and at the behest of many developing countries, in August America and the EU drew up a framework for freeing farm trade. Though it involved some reform, the plan was much less ambitious than Doha had implied. Export subsidies, for example, were not to be eliminated after all.

Angered by this lack of ambition, a new block of developing countries emerged just before the Cancún meeting to denounce the EU/US framework as far too timid. Led by Brazil, China and India, this so-called G21 (see table) became a powerful voice. It represented half the world's population and two-thirds of its farmers. It was well organised and professional.

The new alliance 1

The G21 member countries

Argentina
Bolivia
Brazil
Chile
China
Colombia
Costa Rica
Cuba
Ecuador
Egypt
Guatemala
India
Indonesia
Mexico
Nigeria
Pakistan
Paraguay
Peru
Philippines
South Africa
Thailand
Venezuela

Although it spanned diverse interests—India, for instance, is terrified of lowering tariffs on farm goods, while Brazil, a huge and competitive exporter, wants free trade as fast as possible—the G21 stood together and hammered one message home: rich countries, as the most profligate agricultural subsidisers, should make bigger efforts to cut subsidies and free farm trade. The level of support given to farmers by the rich countries of the OECD has remained more or less unchanged (at over $300 billion) for the past 15 years.

While the fight between Europe, America and the G21 received most attention, another alliance of poor countries, most of them from Africa, was also worried about agriculture, but for different reasons. They feared that freeing farm trade would mean losing their special preferences. (Europe's former colonies, for instance, get special access to the EU's markets for their bananas.) They were even more worried about cutting tariffs than India, fretting that imports would ruin their small farmers. And many, particularly a small group of countries in West Africa, worried most of all about cotton.

Prodded and encouraged by non-governmental organisations (NGOs), especially Oxfam, a group of four West African countries—Benin, Burkina Faso, Chad and Mali—managed to get cotton included as an explicit item on the Cancún agenda. Their grievances were simple, and justified. West African cotton farmers are being crushed by rich-country subsidies, particularly the $3 billion-plus a year that America lavishes on its 25,000 cotton farmers, helping to make it the world's biggest exporter, depressing prices and wrecking the global market.

The West African four wanted a speedy end to these subsidies and compensation for the damage that they had caused. Though small fry compared with the overall size of farm subsidies, the cotton issue (like an earlier struggle over poor-country access to cheap drugs) came to be seen as the test of whether the

Doha round was indeed focused on the poor.

But the draft text that emerged halfway through the Cancún meeting was a huge disappointment. The promises on cotton were vague, pledging a WTO review of the textiles sector, but with no mention of eliminating subsidies or of compensation. Worse, it suggested that the West African countries should be encouraged to diversify out of cotton altogether.

This hardline stance had American fingerprints all over it. Political realities in Congress (the chairman of the Senate agriculture committee is a close ally of the cotton farmers) made American negotiators fiercely defensive of their outrageous subsidies. For the Africans, the vague text was a big blow. It caused “anger and bitterness” said one delegate. As a result, the poorest countries dug in their heels when it came to the other big controversial area: that of extending trade negotiations into the four new Singapore issues. Along with many other poor countries, the Africans had long been leery about expanding the remit of the trade talks at all.

Some of their concerns, such as the fear of overloading their few negotiators, were reasonable. Others made less sense, such as the worry (fanned by many NGOs) that rich countries would use these rules to trample on poor countries' sovereignty. Two days into the conference, over 90 countries signed a letter saying that they were not ready to move into these areas.

Unfortunately, the EU and others who cared about the Singapore issues (a group that did not include the Americans) refused to compromise. Only 24 hours before the meeting was due to end, Pascal Lamy, the EU's chief negotiator, reiterated that negotiations had to proceed in all four areas. Only on Cancún's final morning did he budge, offering to give up two of the Singapore issues. There were even hints that Europe could jettison three, leaving only negotiations on trade facilitation on the table.

Rationally, no country should have objected to that, least of all poor countries. The trade blockages that these rules are designed to minimise cost them far more than tariffs. According to the World Bank, the costs of transporting African exports to foreign markets are five times higher, on average, than the tariffs paid on those goods. Complex, inefficient and corrupt customs procedures make up a big share of these transport costs.

By this time, however, reason was playing little role in the progress of the meeting. The group of embittered African countries refused to negotiate on any of the four Singapore issues. South Korea, by contrast, said it could only accept negotiations on all four. At that point, Luis Ernesto Derbez, Mexico's foreign minister and chairman of the Cancún gathering, said he saw no basis for compromise and declared the meeting over. At the centre of all the negotiations between the different factions, Mr Derbez was better placed than anyone to make that judgment.

Within minutes, delegates who had been set to argue all night over agriculture scrambled to catch earlier flights home. Within hours, the Mexican technicians were dismantling the equipment at the conference centre.

The blame game

Who bears responsibility for this? Some delegates, especially from Europe, blamed Mr Derbez for cutting off discussion too hastily. One British politician claimed his action was “utterly unexpected” and “premature”. Conspiracy theorists claimed that Mexico ended debate at the behest of the Americans who wanted the meeting to fail all along.

That is nonsense. Given the Mexicans' determination to finish the Cancún meeting on time, the Europeans probably made a tactical mistake in retreating so late on the Singapore issues. But Cancún's failure goes deeper than miscalculations on timing. It happened because of intransigence and brinkmanship by both rich and poor countries; because of irresponsible and inflammatory behaviour by NGOs; and because of the deeply flawed decision-making system of the WTO itself.

The instant post-mortems blamed rich countries most. NGOs accused them of wrecking the talks by pushing poor countries too far on the Singapore issues and giving too little on agriculture.

There is much truth to both claims. Europe's ideological attachment to negotiations on investment and competition is hard to fathom, particularly since no European industries were clamouring for them.

On agriculture, moreover, the rich world's concessions were too timid and too grudging. America's bold promises were belied by its actions. Last year's outrageous increase in American farming subsidies, and the cave-in at Cancún by American negotiators to their domestic cotton growers, made far more of an impression on poor countries than Washington's high-minded words about freer farm trade—and rightly so.

Europe was stymied not just by its desire to mollycoddle its own farmers, but by the EU's cumbersome decision-making process. Only after its own internal reforms were agreed to in June could Brussels offer concessions on agriculture, and even then they were meagre. Given the mess that their farm policies create, rich countries should have done far more.

But poor countries, too, bear some responsibility for Cancún's collapse. Although a few emerging economies were tireless negotiators, too many others did no more than posture. Some of the posturing was tactical: for all their public rhetoric, for instance, the G21 group was actively negotiating with both America and Europe. But others, particularly some African countries, could not get beyond their radical public positions. Anti-rich-country rhetoric became more important than efforts to reach agreement.

NGOs, who were at Cancún in force, deserve much of the blame for this radicalisation. Too many of them deluged poor countries with muddle-headed positions and incited them to refuse all compromise with the rich world. The NGOs' main mistake, however, was to raise poor countries' expectations implausibly high. Shout loudly and long enough, they seemed to suggest, and you will get your way. That proved a big miscalculation.

Finally, blame belongs to the WTO's own decision-making procedures, or rather the lack of them. Mr Lamy, with reason, called the WTO a “medieval” organisation whose rules could not support the weight of its tasks. Its predecessor, the old GATT system (which was folded into the WTO in 1995), was run by rich countries. Poor countries had little power, but also few responsibilities.

The WTO, by contrast, is a democratic organisation that works by consensus, but with no formal procedures to get there. Any one of the organisation's 148 members can hold up any aspect of any negotiation. Efforts to create smaller informal groups are decried as “non-transparent” by those left out. Not surprisingly, this lends itself more to grandstanding than to serious negotiation. The worst problem, though, is that the WTO's requirement for consensus makes it virtually impossible for it to be reformed.

Headed for oblivion?

Can any of these failures be addressed and the Doha round be revived? Some countries are more optimistic than others. The G21, for instance, left Cancún determined to stick together and fight another day. Brazil, in particular, is convinced that sooner or later rich countries will be forced to reform their outrageous farm policies. One weapon it points to is the expiration of the “peace clause”.

As part of the trade round before Doha, the Uruguay round, countries pledged not to file formal WTO complaints over the dumping of farm products as long as each country stuck to its (limited) farm-trade commitments. That peace clause runs out at the end of this year. The ensuing flood of disputes, claim some Brazilians, will at last force the Americans and Europeans to negotiate seriously on farm trade.

AFP

Optimists also point to the fact that previous trade rounds all took far longer to finish than planned. The Uruguay round, for instance, took eight years rather than three. According to this view, Cancún's collapse is just par for the course. Maybe. But the risk is that trade momentum will simply move elsewhere.

Even before Cancún's failure, the global trade-negotiating process faced unprecedented competition from bilateral and regional trade deals. Last weekend's events can only reinforce that trend. Bob Zoellick, America's top trade negotiator, claimed that countries were approaching him to push for bilateral deals even as the meeting was crumbling. From a global economic perspective, a tangle of such deals is far inferior to freer multilateral trade. For the poorest countries in particular, the chances of getting from a bilateral deal with America what they failed to get from the Doha round are nil.

If the momentum in trade negotiations moves away from the WTO, the consequences for the organisation itself could be grave. There would then be little political impetus to make it more effective, and the WTO's Geneva headquarters could quickly become no more than a court where disputes on existing trade rules are slowly adjudicated. Far from building a stronger multilateral system, the WTO would quietly sink into oblivion as a negotiating forum. Everyone would lose from this but, once again, the biggest losers would be the poor countries.

Cancún's collapse does not make any of these outcomes inevitable, but it does make them much more likely. That is why it is such a tragedy.

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The California recall

See, Gray: you can get out of anything

Sep 18th 2003 | LOS ANGELES
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Reuters

A weird governor's election has just got weirder

Get article background

THE theatre of the absurd? No, just California, where 1.4m adults—out of a potential electorate of almost 22m—have set up an election to recall their Democratic governor, Gray Davis; and where 135 candidates, from serious politicians to grandstanding pornographers, are contending on a special ballot to replace him. No wonder Bill Clinton, visiting Los Angeles on September 14th to add some populist colour to Mr Davis, said: “It's California I worry about. I don't want you to become a laughing stock, or the beginning of a circus in America where we throw people out for making tough decisions.”

A day later, Mr Clinton looked prophetic when a panel of three federal judges from the famously liberal 9th Circuit Court of Appeals overturned the ruling that had allowed the election to go ahead. Agreeing with a suit brought by the American Civil Liberties Union (ACLU), the three judges decided that the recall vote, scheduled for October 7th, should be delayed until March 2nd, thus giving Mr Davis, whose governorship had looked imperilled, more time to prove his case.

Since then, chaos has been the order of the day. The other members of the 9th Circuit Court are now considering the panel's ruling, with indications that the court will make a decision by September 24th. Some proponents of the recall think the judges will re-establish October 7th as the date. Others are pinning their hopes on an emergency sitting of the US Supreme Court itself (though that eminent body, which is not scheduled to begin its next formal session until October 6th, could in theory decide to ignore the whole sorry business). Meanwhile, the political classes are trying to work out whom the delay will favour most.

First, consider the legal issues—though even this comes with a political health warning. The judge who last month ruled against the ACLU is a Republican appointee; the trio who this week overturned his decision are Democratic choices. Mix in the adventurously leftish nature of the 9th Circuit Court (it has suffered more reversals than any other appeals court, witness its attempt last year to excise the words “Under God” from the pledge of allegiance), and it is easy for the Republicans to cry foul—just as easy, in fact, as it was for the Democrats to do so almost three years ago when the mainly Republican-appointed Supreme Court ruled in George Bush's favour in the general election.

The panel's ruling this week, point out Democrats, is based on the Supreme Court's judgment in the Florida case that “the right of suffrage can be denied by a debasement or dilution of the weight of a citizen's vote just as effectively as by wholly prohibiting the free exercise of the franchise.” In other words, if misbehaving chads were enough to imperil a proper count in Florida, why take that risk in California, where old punch-card machines, with a “propensity for error” allegedly two-and-a-half times greater than for any other system, are still the only ones available in six of the state's 58 counties? Those six counties, among them Los Angeles and San Diego, account for 44% of the state's electorate and include a disproportionate share of ethnic minorities and the poor.

California's previous (Republican) secretary of state declared the punch-card system “unacceptable” last year; the current Democratic one has banned its use in future elections. The panel wants to postpone the recall ballot until “the next regularly scheduled statewide election six months from now, when the secretary of state has assured that all counties will be using acceptable voting equipment.” The risk otherwise, calculate the three judges, is that “approximately 40,000 voters who travel to the polls and cast their ballots will not have their vote counted at all.”

Republicans, muttering about “judicial hijacking”, point out that there were no complaints when punch-card machines helped re-elect Mr Davis only last November: he won by 360,000 votes so it is unlikely that 40,000 votes will matter this time (though the big field to replace Mr Davis may increase the odds of controversy in that part of the ballot). At this late stage, surely it makes more sense to go ahead: if there is a problem, the Democrats can by all means appeal later. And, as for disenfranchising people, what does the delay mean for the 375,000 people who have already sent in postal ballots?

Some proponents of the recall argue that federal courts, such as the 9th circuit, have no business interfering in state elections. The Republicans may have to adapt that line if they appeal to the Supreme Court—as some are already thinking of doing. When the highest court intervened in Florida, it stressed how rare it thought such interventions should be.

Arnie's headache

Another objection to the ruling is that it changes the nature of the campaign. A short sprint now becomes a marathon. And that change seems to benefit one candidate in particular: Mr Davis.

The governor, who needs to win the approval of 50% of the voters, has yet to get more than 47% in the polls, though he has been gaining ground. He will have more time to woo his disenchanted public; more time to wheel out Mr Clinton to charm people like the gospel-singing blacks with whom Mr Davis looked so ill-at-ease last weekend; more time to discredit opponents, especially Arnold Schwarzenegger; and more time to reverse a pro-recall tide that is already starting to ebb. A March vote would coincide with the presidential primary and elections for the state legislature—events that will lure more Democrats to the polls.

By contrast, a later recall does not help Mr Schwarzenegger. It is one thing for the movie-star to run a quick campaign aimed at the star-struck (this week his assault on the voters included interviews with such political heavyweights as Oprah Winfrey, Howard Stern and Larry King), quite another to answer tricky questions on policy in a limelight lasting six months and costing large amounts of money.

A longer race and wider exposure might also push the claims of other Republicans. State Senator Tom McClintock—a true conservative, unlike pro-choice Arnie with his pot-smoking, groupie-groping past—may see even less reason to withdraw in the actor's favour. Two other Republicans who have dropped out—Peter Ueberroth, who organised the 1984 Los Angeles Olympics, and Bill Simon, Mr Davis's electoral opponent last year—might re-enter the contest.

On the other hand, conventional wisdom could turn out to be hopelessly wrong. Mr Davis has been on something of a roll in the past two weeks. By January, he will be struggling to present another budget. Since his starting point will be a deficit of at least $8 billion, he will have to raise taxes and/or cut spending—not exactly a recipe for electoral success. Meanwhile, Mr Schwarzenegger will have more time to improve his grasp of the issues. Mr McClintock could decide that staying in the state Senate is a safer bet than bidding for the governorship. And there may even be some new Democratic challengers.

The one thing that is certain is that the process of American democracy, much abused at the time of the Florida recount, has taken another battering. Punch-card voting systems are still used in 26 states. And many people will wonder about a process that forces a recently elected governor to go through such a

charade. As Mr Clinton predicted: “You could do some pretty serious damage, long term, not only to California but to the fabric of democracy. I think it could make California look like an unpredictable place to do business and an unpredictable place to invest. It could spread like a virus.”

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Folk art

Salvation Mountain

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Remember when California used to be optimistic as well as bizarre?

IN THE fierce heat of the Californian desert, you feel as if you have seen Babylon: a shimmering hillside garden of cascading waterfalls, flowing streams and verdant trees. Once you get closer, you find that Salvation Mountain is actually a huge collage, 40 feet high and 100 feet wide, built on the side of a desert bluff from a mixture of adobe and household junk (kettles, refrigerators and great trees of used tyres) and then painted with garish animals, birds, flags and religious writings.

The aim of Salvation Mountain is appropriately Californian: to inspire people to love each other. Its creator, Leonard Knight, a gnarled veteran of both the Korean war and the 1960s, originally thought of celebrating his religious fervour by building and flying a 300-foot-high hot-air balloon. That project failed when the fabric rotted; so since 1985 he has been working on the mountain. So far, he has used up 100,000 gallons of paint.

Salvation Mountain stands at the entrance to “Slab City”, an old army base that has now been converted into a somewhat Mad-Maxish desert town—part trailer park, part new-age community. The residents of Slab City offer materials for the Mountain and sustenance for the artist, who lives in a couple of luminously painted trucks.

The Mountain has its disbelievers. In 1994 state officials tried to bulldoze it, claiming that the toxins in Mr Knight's paint were a health hazard. Soil tests proved them wrong, and now Mr Knight is dangerously close to respectability. Senator Barbara Boxer has described Salvation Mountain as a national treasure and “a sculpture for all the ages”. The Folk Art Society of America has declared the site “worthy of preservation and protection”.

On a good day it gets 150 visitors, each of whom is escorted up the bright yellow pathway that reaches the top of the bluff. For Mr Knight, the pervasive message is “God is love”, but he also sees his work as an antidote “to those people who tell you how you should deal with your spiritual side”. He begins to elaborate on this theme, but then stops. “I'm letting my mouth get in the way again. Let the mountain do the talking”. Which it does very well.

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The budget

Iraq and a hard place

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The politics of rising budget deficits are turning sour for George Bush

PRESIDENT BUSH wants guns (Iraq) and butter (tax cuts). The cost of having it both ways is mounting, for him as well as for the country. On September 7th, he presented the latest instalment of the Iraq bill: $87 billion next year. He did it in a nationally televised speech, a sure sign of how much his political future depends on events in the Gulf.

Usually, Mr Bush's set-piece speeches turn public opinion to his advantage. This one did not. A *Washington Post* poll found 61% of respondents opposed to granting the extra money. As Stan Greenberg, a Democratic pollster, pointed out, this would be the first time in the Bush presidency that the bully pulpit has failed to swing the public.

That failure partly reflects growing concern at lack of progress in Iraq: concern so alarming to the White House that it put its top guns on last Sunday's television talk shows to defend its record. Dick Cheney (who rarely talks to the press in public these days) dismissed criticism that strategy in Iraq needs changing. The vice-president even surprisingly returned to the idea that Saddam Hussein may have had something to do with al-Qaeda.

This uncompromising defence may not persuade many people that the $87 billion will be money well spent. But this is not because they oppose America's actions in Iraq. True, half the population does not think the administration has a proper plan for the country (against three-quarters who said it did in March). But this scepticism does not extend to America's basic aims, or to Mr Bush himself. The rating for his handling of Iraq has slipped a bit, but a majority still approves. His overall ratings are dropping, but only marginally. At least six in ten people still say America was right to go to war, and this number has been steady for months.

It seems likely, instead, that lack of enthusiasm for spending money in Iraq has as much to do with the cost, and the impact this has on the budget deficit, as with Iraq itself. Americans, it appears, are not convinced they can have both guns and butter, even if the administration seems to think they can.

The $87 billion request brings up these worries because it is the last straw on the overburdened camel. In July, the administration's Office of Management and Budget increased its estimate for this year's budget deficit from $300 billion to $450 billion. In August, the Congressional Budget Office put the figure slightly lower. Neither figure includes the extra $87 billion. If you add that in, the budget deficit will increase next year from 4.2% of GDP to around 4.7%.

The administration pooh-poohs the deficit as manageable and claims that economic growth will erode it away. It may not do so, because the deficit is compounding more general economic worries that are causing alarm in Congress—and not only among Democrats.

Trouble on Hill

Republican congressmen and senators returned from their summer recess agonising about “a sense of drift” (Henry Hyde of Illinois), “deep concern” (Senator John McCain) and, especially, jobs. “It is not possible for you to talk about jobs too much,” ran a memo to congressional Republicans from the chairwoman of the party's conference in the House, Deborah Pryce of Ohio. The memo was released at a private meeting of the party's congressional representatives which turned into a venting session against the administration. Congressmen complained about everything from mounting job losses, to free trade, to the failure of the White House to consult with congressional allies. Alarmed by the reaction, the

number two in the Republican hierarchy in the House, Tom DeLay, called the White House communications chief to the Capitol to work out how to get the $87 billion spending bill through Congress.

Fraying Republican discipline is already giving Democrats a rare chance to make life difficult for Mr Bush. This week, Democrats teamed up with Republicans to overturn a proposal by the Federal Communications Commission to loosen rules on media ownership. They did this in the teeth of a threatened presidential veto. Last week, Democrats blocked proposals to change the rules governing overtime pay for many middle-income employees, a rare victory for labour unions.

But the real problem for the administration is that congressional restiveness will make it harder to cut spending, and hence reduce the budget deficit. The administration is proposing spending increases anyway, especially on defence. Mr Bush also wants the current session of Congress to pass a big expansion of the Medicare programme. With Congress worried that the economy is not growing fast enough to generate employment, representatives will hardly be in a mood to make large cuts in other areas to offset these increases. And no Republican is willing to forgo any future tax cuts. Indeed, they want to make supposedly “temporary” cuts permanent.

There are two conclusions. First, the administration is underestimating the size of the budget deficit and overestimating the chances that GDP growth will take care of it. Current estimates exclude the extra spending in Iraq, make Pollyanna-ish forecasts about spending restraint, ignore changes to Medicare and assume Mr Bush's “temporary” tax cuts will stay that way. A more realistic estimate for the deficit is around 6% of GDP in the next year or two, equal to the largest-ever post-war deficit in 1983. At some point, rising interest rates may well force belt-tightening upon the administration, overturning its insouciant view that the deficit will solve itself.

Second, Mr Bush's campaign in 2004 will be crimped by his budget problems now. In 2000, at a time of surpluses, he was able to present himself as a new sort of conservative, promising tax cuts and expansive government programmes (defence, education) while niftily paying off the national debt. Now he will have less room to offer something to everyone. He will seem more like a traditional conservative, wondering how to rein in spending and how to balance a strong defence against social programmes. In short, he will face an old choice: guns or butter?

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The lady's not for turning

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AP

As *The Economist* went to press, Hurricane Isabel was hurling winds of 110mph towards the eastern seaboard. Although the Category 5 storm had slackened to Category 2, Washington had braced for it, closing down transport and schools. George Bush left the White House for Camp David, though Maryland, too, was in the path of the storm.

Officials in North Carolina, where Isabel was expected to land, insisted that over 100,000 people leave the coastal counties, and 40 warships were moved for safety from the Norfolk naval station in Virginia. Yet the biggest anticipated damage was not from wind, but flooding; after a wet summer in the east, the water table is much higher than normal.

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Energy policy

Hot air rising

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Congress is at last taking energy policy seriously. This is probably bad news

AFP

IT MUST be the most boring topic in the world. Mention hydrocarbon scarcity or carbon emissions at a dinner party, and people could question your sanity (probably correctly). Until recently the electricity grid was hardly a door opener either. So it is something of a surprise, then, to see Congress suddenly enamoured of the subject of energy.

After years of debate and delay, America is finally coming to grips with energy policy. Republicans spent the week trying to reconcile the Senate and House versions of a massive energy bill. Democrats groused that they were being shut out from this process just as they had been excluded by Dick Cheney's energy task-force (which this week vowed to go to the Supreme Court to avoid revealing which fat cats from the industry it had consulted). George Bush, for his part, travelled to a coal plant in Michigan on September 15th to trumpet the supposed greenness of his policies. The next day, he met utility bosses at the White House to promote his controversial “Clear Skies” proposal for reducing power-plant emissions.

So why exactly is energy so sexy right now? The short answer is the great North American blackout. That episode, which left tens of millions without power on August 14th, has pushed Congress to act on energy—though this is no guarantee of sensible action. Indeed, there is every sign that it will fail to do the only things that require government action now—fixing electricity deregulation, curbing subsidies and dealing with climate change.

Consider electricity reform, for a start. Mr Bush's energy secretary, Spencer Abraham, is heading a joint investigation into the power cut with his Canadian counterpart. The group's experts have just released some preliminary findings, but a definitive explanation is probably weeks off. Such is the political pressure to be seen doing something, however, that Congress is unlikely to wait for the final report before acting.

Unfortunately, it seems unlikely that Congress will tackle the root causes of the power cut—namely, a deeply flawed deregulation plan, a weak federal regulator and inadequate reliability standards for the

grid. John Dingell, a Democratic congressman from Michigan, is nobly trying to persuade his colleagues to strip out the electricity-reliability provisions of the energy bill so that they do not get lost in the unrelated battles over drilling for oil in Alaskan wilds and subsidising “clean coal” research. One Washington insider explains why this is unlikely to happen: “Without electricity in it, the energy bill wouldn't fly. There are only two big drivers for this legislation: power and ethanol subsidies.”

That points to the second area where government action is justified in energy policy: subsidy reform. With the possible exception of agriculture, the energy industry enjoys more outrageous subsidies, market distortions and other forms of disguised aid than any other. Worse still, because of the dirty nature of much energy production and use, these tend to be environmentally harmful as well. Green Scissors, one pressure group, has calculated that the House version of the energy bill would hand out $28 billion in subsidies to the fossil-fuel and nuclear industries. The Senate version is only somewhat less offensive.

Far from reducing subsidies, however, Congress seems likely to invoke the blackout to justify further handouts to suppliers. The provisions on oil drilling in Alaska are probably too controversial to pass, but support for a natural-gas pipeline may be thrown in as a sop to the state instead. The nuclear industry seems likely to win subsidised insurance and perhaps production credits. Not to be left out, the wind lobby may win similar credits too.

In this sordid business, Congress is merely following the lead of Mr Bush, who has insisted—on absolutely no evidence whatsoever—from his first days in office that America is mired in a serious “energy supply crisis”. Indeed, at his speech near blacked-out Detroit this week, he invoked crisis once again to justify his policies: “Lights went out last month—you know that.” Yet the lights did not go out because of any scarcity of power-generation capacity or of fossil-fuel supply.

A change in the weather

Perhaps the most disheartening aspect of the current energy debate, if it can be called that, is the fact that climate change will largely be ignored. It is very unlikely that this Congress will produce a bill that includes effective measures to curb carbon emissions.

Yet there is good reason to think that any serious energy policy must include mandatory curbs on greenhouse gases. A recent study by the OECD suggested that voluntary programmes alone are inadequate. The hard evidence from the 1990s suggests the same: toothless voluntary approaches allowed America's greenhouse-gas emissions to soar. More persuasive is a thoughtful new study of the energy future by the Pew Centre on Global Climate Change. Even on the most optimistic assumptions about technological innovation, it suggests, America will not be able to make a dent in its greenhouse-gas emissions without some form of tough-nosed mandatory federal laws.

So will it ever happen? On September 16th, a bipartisan bill was introduced in the House that would add carbon dioxide to the three conventional pollutants (sulphur dioxide, nitrogen oxides and mercury) tackled by Mr Bush's Clear Skies proposal. Several senators have proposals to cap carbon emissions in the works.

Most interestingly, John McCain seems to have extracted a promise from the Republican leadership that his proposal (co-sponsored by one of the Democratic presidential candidates, Joe Lieberman) for tackling carbon emissions will get a stand-alone vote on the floor of the Senate this autumn. This measure would cover the whole economy (not just power plants) and also include carbon trading. Mr McCain's proposal had previously been considered dead on arrival, as both the car and energy lobbies loathe it.

The odds are still against any of these more inventive proposals getting through. If one did somehow make it to the White House as part of an omnibus energy bill, it would pose a quandary for Mr Bush. The man who brushed aside the UN's Kyoto treaty on climate change so brutally and who dispatched his energy secretary to Berlin this week to reinforce America's position would surely want to veto any mandatory federal rules on greenhouse gases; but he is otherwise all set to sign just about any pork-laden monstrosity Congress constructs. More is the pity on both counts.

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New York City prisons

Needed: crooks

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Too much jail space is the city's newest problem

Get article background

A THIN strip of granite facing is being wrapped around the first floor of the bleak 800-cell Brooklyn House of Detention, a visible sign that a $45m renovation is creeping forward. The question is whether anyone can be found to go into it.

The jail, built in 1957 near the old Brooklyn courthouses in the stark “brutalist” style popular among architects but not people, served as an early example of inept urban renewal. A neighbourhood that included a church, small houses and businesses had been damaged by subway construction; it was replaced by a concrete jail surrounded by forlorn concrete lots. Economic renewal, such as it was, came from the conversion of several shops into places for bail bondsmen to ply their trade.

Attempts to modernise the prison began a decade ago. Revised building codes prompted slow renovations and then modest improvements, such as a new waiting room for prisoners' families. There is even some effort to spruce up the awful look of the place. All that is missing from this display case of correctional excellence is a few criminals to put in it.

The number of prisoners may have been rising quickly in America as a whole over the past decade, but in New York City, it has been falling. The city's sharp decline in crime, which began under Mayor Rudy Giuliani but has continued under Michael Bloomberg, pushed down the average daily number of people behind bars from 23,000 in 1991 and 19,200 in 1997 to under 14,000 today. These people all fit handily on the city's main “prison island” in the East River. Altogether, five New York prisons are short of jailbirds, but as David Yassky, a local councilman, points out: “If there ever was a white elephant, the Detention Centre is it.”

New York is not alone in this respect. Crime has gone down in other cities, and there has also been a splurge of jail building in the countryside, sucking in the available criminal talent. Some 30 old prisons have been transformed into museums. The most famous, Alcatraz in San Francisco Bay, boasts a Brooklyn boy, Al Capone, as its star alumnus.

Brooklyn may have some hope in this respect. Capone made his name in Chicago, but his untoward instincts were hardly unique in his birthplace—the House of Detention has had its own rub with infamy. Its old boys include Jack Abbott, an author-murderer, Bernard Goetz, the subway vigilante and mayoral candidate, and even the Rev Al Sharpton, who has been accused of most of these things and is now running for the presidency. A longer, more definitive, list could no doubt become a marketing campaign.

Alas, many locals would rather bury their concrete bunker, rather than celebrate it. The House of Detention sits on a key road-crossing, and consequently Brooklyn's politicians and merchants would like nothing better than to blow the place up and replace it with a mall. After all, a large prison in Northern Virginia was recently converted into housing.

New York City officials, however, are adamant about keeping the House of Detention as a house of detention. They believe that getting another site for a jail, if ever one were needed, would require years of fighting local residents, regardless of where they tried to plonk it. They have also learned to be sceptical about trends in crime. “Just as the jail population has dropped, it could go up again,” says Martin Horn, commissioner of the Department of Corrections. For instance, the number is currently below where it was at the beginning of the year, but it has surged by 700 in the past three weeks alone.

Regardless of need, the city also has a well-established reluctance to give up property voluntarily. Two miles away from the House of Detention is another old jail, known as “The Brig” because of its connection to the old Navy Yard. Its last prisoner cleared out in 1994, but the Department of Corrections surrendered the facility to the city only last year and since then the city has sat on the property.

This style of defensive urban asset-management comes with what economists call an opportunity cost. Another consequence of the decline in crime has been a resurgence of many previously run-down neighbourhoods, including central Brooklyn, on the edge of which sits the House of Detention. Archaic zoning restrictions have been loosened up. Breaking with precedent, Mr Giuliani waged a bitter battle to force the city to sell a municipally owned parking garage to the west of the House of Detention. The site was purchased for $16m by a developer who took the rare step of actually developing a new property in downtown Brooklyn. To the north of the House of Detention a similar process unfolded around the former headquarters of the city's education bureaucracy, which went for $45m.

This rehabilitation could be spurred by the sale of the unloved House of Detention. The sale could also bring in $35m-50m, no small matter in a difficult time. Missing the opportunity, say the House of Detention's many critics, would also be a crime.

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Lexington

And then there were ten

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Blow-dried Napoleon or Clintonised Ike? Wesley Clark puts even more pressure on George Bush to sort out Iraq

THE reluctant warrior is reluctant no longer. On September 17th, Wesley Clark finally threw his epaulettes into the ring. His campaign had toyed with making the announcement in Little Rock's MacArthur Park. But somebody realised that Douglas MacArthur's career was not entirely unblemished (there was the little business of being relieved of his command for trying to start the third world war). So they chose a boys' and girls' club.

Mr Clark's arrival was another jolt for a punditocracy that is increasingly convinced of George Bush's vulnerability next year. Doesn't Mr Clark come from the same state as Bill Clinton? (In fact, he was born in Chicago, moving to Little Rock when he was four, but there are plenty of similarities, including their time spent as Rhodes scholars; and, unlike Mr Clinton, he continues to live in Arkansas.) And doesn't he share the same profession as Dwight Eisenhower? In fact, he did not have quite as grand a military career as Ike. But his CV is pretty impressive: first in his class at West Point, honoured for his courage in Vietnam, a former supreme commander of NATO and the conqueror of the Yugoslav dictator, Slobodan Milosevic.

Mr Clark's announcement is a damning verdict on the Democrats' performance so far. You don't enter a race at such a late stage—many of the leading candidates have already been on the stump for a year—unless the field leaves a lot to be desired. The only candidate who has generated any electricity is Howard Dean. But Mr Dean is vulnerable to the charges that he is too left-wing for such a conservative country, and too irascible for such an optimistic one. The other candidates all have conspicuous weaknesses: John Kerry is too aloof (or French-looking, as the Republicans have it); Dick Gephardt is too wedded to the trade unions; John Edwards is too inexperienced; Joe Lieberman is too pro-war. In last week's debate in Baltimore, the best performance came from the magnificently unelectable Al Sharpton.

Does Mr Clark stand a chance of revolutionising the race? Two things suggest he might. The first is that Mr Clinton took advantage of equally deep divisions in his party by making an even later entry into the primaries—in October 1991. The second is that many Democrats are desperate to find somebody to beat Mr Dean: hence the talk of drafting Al Gore.

This is not to say that Mr Clark will have an easy job. Starting a race this late in the game is hard. The

established candidates have already spent more than $20m between them. Unlike Mr Clinton, Mr Clark has never run for office before. Indeed, he has spent his career in an organisation that is the very antithesis of the fluid mess that is a modern presidential campaign. He also has an unfortunate addiction to micro-management (until now, he has insisted on dealing with press inquiries himself). Worse, he is a neophyte when it comes to domestic policy. While Mr Clinton could talk the hind legs off a donkey about everything from teacher testing to welfare reform, Mr Clark is visibly uncomfortable with such wonkery. He has only just discovered that he is a Democrat.

Yet Clark the campaigner has more up his sleeve than you might think. For one thing, he is a southern centrist in a party that is petrified of being too liberal and north-eastern. For another, he is intensely ambitious—a hard-working man with an irrepressible drive to be first in his class. He deliberately burnished his national reputation by becoming a military-affairs analyst for CNN. He is attracting several important people from the Clinton-Gore wing of the Democratic Party, including Mr Gore's former chief of staff, Mark Fabiani. The Little Rock branch of the Draft Wesley Clark campaign is based in a recently renovated building that will make a good base for a presidential campaign, already equipped with such gadgets as wireless internet access.

General Dynamic or General Accident?

But Mr Clark's most priceless assets are his four stars. The Democratic Party's biggest weakness is the suspicion that it is unqualified to fight the war on terrorism. (James Carville likes to joke that, as a former corporal in the marine corps, he was the highest-ranking military officer in the Clinton administration.) Mr Clark is better placed than any of his fellow Democrats to rebut such criticisms—and to tell the Bush administration “I told you so” on Iraq. Mr Clark's argument (laid out in a forthcoming book) that the best way to manage America's “virtual empire” is through subtle diplomacy rather than Bush-style bluster may well pick up a few prominent military supporters, who will doubtless remind voters that they, unlike those effete neo-conservatives, actually know what it is like to be under fire.

Mr Clark's military record may come under scrutiny. In Kosovo, the diplomatic multilateralist clashed with British commanders who thought he wanted to start a world war by attacking the Russians. He also clashed with Mr Clinton's defence secretary, William Cohen. He was steadily shut out of decision-making in Washington as the war progressed, and was relieved of his command before his term was up.

The Kosovo war was also an archetypal liberal war, unsullied by any question of America's national interest. Republicans will ask why this “blow-dried Napoleon” (as Tom DeLay has dubbed him) is so keen on humanitarian intervention when America's national interest is not at stake, and so hostile when such intervention has the added bonus of making Americans safer from terrorist attacks.

Yet such partisan criticism can never negate the advantage of having a four-star general in the Democratic column. Mr Clark is a long shot at the moment. But his candidacy gives added weight to the Democrats' criticisms of Mr Bush's foreign policy. And it also increases the likelihood that he will appear on the Democratic ticket as a vice-presidential candidate. Mr Bush's stake in a dramatic improvement in Iraq has just got a lot higher.

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Colombia

The children's stories

Sep 18th 2003 | BOGOTÁ
From The Economist print edition

KATZ FSP

A new report on young combatants adds fuel to a furious row between Álvaro Uribe and the NGOs

Get article background

“OSCAR” was 12 when he joined the AUC, the right-wing paramilitary forces in Colombia. “My squad had to kill three people”, he told investigators. “I had to shoot [a captive] in the head. I was trembling. Afterwards, I couldn't eat. I'd see the person's blood.”

Thirteen-year-old “Ramón” (all these children's names have been changed, for security reasons) was fighting for the other side: the left-wing Revolutionary Armed Forces of Colombia, the FARC. He described executing an army sergeant who had infiltrated the FARC's 43rd front. “In the night, I couldn't sleep, I was so scared. I sensed that he was standing at my feet.”

On September 18th, Human Rights Watch, a Washington-based group, released the first full report on the child soldiers involved in Colombia's civil war, which has now raged for 40 years. Largely on the basis of interviews with 112 children who were either captured by or had escaped from the FARC, the AUC and the ELN (a smaller leftist militia), the group determined that more than 11,000 child soldiers may be fighting in the war, about 26% of all irregular armed combatants. This puts Colombia in the top tier of countries plagued by children with guns, alongside Burma and Uganda.

By and large, investigators found that Colombia's children are not forcibly recruited. Instead, they join up because of “lack of opportunities”, including poverty, poor schooling and violence at home. The guerrilla forces or the AUC treat them, thrillingly, as adults, immediately giving them revolvers and training them to handle AK-47s and 9mm pistols. FARC children are also taught to deploy gas-cylinder bombs, a deadly but inaccurate weapon often used to attack police stations. As part of basic training, five ex-AUC children were forced to kill prisoners.

When they break the rules, child soldiers are punished. For falling asleep on guard duty or trying to desert, FARC and ELN children are hauled before “war councils”. These have a prosecutor and a spokesman for the defence, but the accused child may not speak. After the council, a show of hands determines whether or not the child will be killed. Most are, with the executions often carried out by other children. Those who are spared may be chained to a tree for months, or ordered to dig trenches.

Summary executions and torture of enemies are also carried out by child soldiers. Forty of the children

interviewed had taken part in killings outside combat. Child paramilitaries, who, in contrast to FARC and ELN children, are paid a salary, get bonuses of about $167 for killing guerrillas or their alleged civilian collaborators. And if they do not do the killing or torture themselves, they are often forced to watch. “How do they torture?” asks “Adolpho”, who joined the AUC at the age of 13: “They pull out their nails, they throw hydrochloric acid in their face and body, and they burn them up with fire.”

The report makes several recommendations to the armed groups and the Colombian government, appealing for an end to child recruitment and for programmes to rehabilitate the children when their deadly careers are over. Yet neither side is much inclined to listen. The armed groups, of course, are beyond appealing to, except in the court of world opinion. But Colombia's popular and uncompromising president, Álvaro Uribe, has chosen this moment to launch a wild and wide attack against all human-rights groups and other non-governmental organisations (NGOs). He sees them as apologists for terrorism and sympathisers with the FARC, whom he has struggled to have branded as terrorists in Latin America and Europe. (The recent kidnapping of eight tourists in the north has been laid firmly on the FARC by the president, though they deny it, blaming men from “military intelligence”.) His defence minister, Martha Lucía Ramírez, has just announced that 113 NGOs will be investigated.

The cause of Mr Uribe's anger was a recent report by 80 Colombian NGOs, “The Authoritarian's Curse”, which attacks his record on human rights. That record is not a glowing one. The army continues to be too close to the paramilitaries and, only recently, Mr Uribe proposed giving “alternative”, or softer, penalties to surrendering paramilitaries who have committed crimes against humanity. But he has made things worse by flying off the handle: possibly jeopardising both the political opposition to the FARC, which he has worked so hard to craft, and aid from other countries, especially the United States. Colombia gets the third-largest amount of American aid, after Israel and Egypt.

In response to the president's attack, José Miguel Vivanco, the Americas director of Human Rights Watch, admits that human-rights abuses have actually declined during Mr Uribe's year in office. The president should use this fact, he thinks, to disarm his critics. Besides, the NGOs, including his own, have plenty of dirt on the FARC and are not shy of giving it publicity.

Indeed, the report on child soldiers points out that the FARC has by far the most children in its ranks: it estimates that 7,400, or 25%, of the force is under 18. Typically, recruits are between the ages of 11 and 13. But in terms of training, combat and discipline, the report holds all the factions equally responsible. And the shame touches all Colombia.

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Mexico's women

A few shots at power

Sep 18th 2003 | MEXICO CITY
From The Economist print edition

Rising expectations are still not much threat to the men

AP

Hayek as Kahlo, both role models

WHO is the most popular person in Mexico today? No doubt about it: showing a pair of spiked heels to all-comers is Ana Guevera, the sprinter who won the 400m title at the athletics World Championships in August. She is well on her way to becoming Mexico's most successful athlete ever; her face now beams down from thousands of advertising hoardings, selling everything from bread to telecoms.

Women are rising to the top of many sectors of Mexican society. Salma Hayek, a soap-actress-turned-film star, has earned much praise for “Frida”, a biopic of the painter Frida Kahlo, herself a feminist icon. Lorena Ochoa is doing startlingly well on the professional golf circuit. And the president's wife, Marta Fox, who runs her own charity, probably earns more column inches than any other public figure. Whatever their views of her conservative Catholic politics, many Mexicans admire her energy and advocacy. Mrs Fox gets higher job-approval ratings than most of the country's male politicians.

It is in politics that a changing balance of the sexes is most visible. In the mid-term elections in July, the only bright spot, amid the general apathy, was the record number of women returned to the federal Congress. They now make up 116 out of 500 members, a 6.4% increase on the Congress before. In Mexico City, 33% of the seats in the city's assembly were won by women. The most important figure in Mexican politics is now Elba Esther Gordillo, the head of the Institutional Revolutionary Party (the PRI, which used to rule the place), in the lower house of Congress. And, until last month, the leader of the biggest leftist party was Rosario Robles.

In business, too, women have become chief executive officers of both domestic Mexican companies and the Mexican offices of international companies. Leticia Narváez, president of the Mexican Association of Women Executives, argues that the acceptance of women in business has “improved a lot over the past 15 years”. However, the mere fact that Ms Narváez had to set up her organisation three years ago suggests that equality with men in business “is not happening organically”. The association aims to provide the same sort of networking opportunities among women executives that men take for granted. The association has just held its first Saturday outing to a museum, the female alternative to executive boxes at the soccer game or the bar at the golf club.

Ms Narváez argues that this sort of solidarity is essential. For all the success, there is still a long way to go. Some companies, she points out, still specifically seek men rather than women to fill executive positions. And official figures confirm a continuing gap in income between the sexes. In ten out of the 11 main employment sectors, men earn more than women, a disparity that rises to as much as 40% among shop-floor supervisors in factories. If this income inequality were to be redressed, it is estimated that women, on average, would have to be paid 14.4% more.

It is not for nothing, therefore, that some feminists argue that successful women in Mexico are mere tokens. Even in the hopeful professions, such as politics, appearances can be deceptive. In government, women still get only the “soft-issue” ministries, such as tourism and culture. The economy and justice departments, let alone the presidency, seem closed to them. It would be very hard to imagine, as in Colombia, a woman as defence minister.

In both politics and business, too, the working day is still arranged around the lifestyle of a man. Ludicrous school hours, running from 9am until 1pm or 2pm, mean that children have to be picked up in the middle of the day, and there are very few crèches or arrangements for child care, beyond asking relatives to help.

More women in Congress might help change this. But probably only a bit. As long as every political or official event is made colourful by *edecanes,* shapely hostesses in skin-tight skirts, Mexico's macho culture is in no danger of disappearing.

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Canadian drug policy

Needling the neighbours

Sep 18th 2003 | VANCOUVER
From The Economist print edition

The first drug-injection clinic comes to North America

BEAUTIFUL though it appears, Vancouver has an ugly drug problem. The past ten years have seen a steady rise in gang killings, violent robberies and break-ins. Drug-dealing is done openly. Hospitals report soaring rates of disease from dirty needles, as well as shocking deaths from overdoses.

Three years ago the former mayor, Philip Owen, launched a new drug strategy with “four pillars”: harm-reduction, prevention, treatment and enforcement. On September 15th his successor, Larry Campbell, whose keen support for the plan helped him get elected last year, took a big practical step by opening the first supervised drug-injection clinic in North America.

The clinic, called “Insite”, is in a renovated shopfront in the heart of the gritty Downtown Eastside, home to more than half the city's estimated 8,000 intravenous drug addicts. If they go there, it is hoped, they will stop shooting up in squalid back alleys. Instead, as many as 800 addicts a day will be able to inject their own drugs with clean needles in a safe place, supervised by a nurse and without fear of arrest. Nurses will also treat minor wounds and infections, and make referrals for further health care. “Peer counsellors” (former addicts) will teach safe injection practices and, with addiction counsellors, will help addicts enter treatment when they are ready.

Insite will cost about C$2m ($1.5m) a year to operate, and is funded by both the British Columbian and Canadian governments. But it is not yet intended to be permanent. It has been set up as a three-year research project (hence its exemption from the reach of the law) to assess whether a service like this can reduce drug diseases and deaths.

It will not be easy. The clients care little about their health, and the problems are immense. More than 30% of local addicts have HIV, the precursor to AIDS; more than 90% have hepatitis C, and the past five years have seen 524 deaths from overdoses. “We are never going to cure addiction,” admitted Mr Campbell at Insite's opening. “But what we can do is help those who have that addiction to stay alive and healthy until we can help them get into some sort of treatment.”

Experts say this approach has succeeded in the 27 other injection sites in Europe and Australia. But addicts take time to be persuaded that they will not be arrested on the doorstep. Vancouver police want this project to succeed, says their chief, Jamie Graham, vowing that his men will exercise discretion in letting people get to the clinic. But there will be “no bubble zone” around the site; drug-dealers loitering there will be nicked. Addicts say they still feel wary of what the police may do.

Much of the public is sceptical, too, but few have attacked the scheme outright. An exception is the right-wing Canadian Alliance Party, which argues that Insite will simply encourage abuse. Unsurprisingly, more concern has come from south of the border. The Insite experiment—together with a bill in Parliament to decriminalise possession of marijuana—has brought dark murmurings from top anti-drug officials in the United States: Canada, they say, is going soft in the war on drugs.

The plain fact is that for almost three decades, buttressed by the recommendations of a national commission and two parliamentary reports, Canadian public opinion and official policy have been moving away from treating drug abuse solely as a criminal offence. “We're heading very cautiously down a path that more closely resembles European than American drug policy,” says Neil Boyd, a criminologist at Simon Fraser University. Mr Boyd would like Vancouver to take the next step, already endorsed by many European cities and by a Canadian commission 30 years ago, of prescribing heroin to hard-core addicts. That, he believes, might reduce both the growth of heroin addiction and criminal activity. But try telling that to the United States.

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Venezuela

Back to the drawing board

Sep 18th 2003 | CARACAS
From The Economist print edition

The petition for a referendum is rejected

Get article background

THEY were not that surprised. When Venezuela's heterogeneous opposition presented their petition for a national referendum on President Hugo Chávez to the electoral authorities (CNE), they already knew it was flawed; and when, on September 12th, the CNE rejected it, the petitioners had a full-colour, nicely printed timetable for a re-run of the operation ready within minutes.

Under the 1999 constitution, a referendum is allowed after the mid-point of the presidential term. In the case of Mr Chávez, whose clumsy authoritarian populism is exhausting his country, that date fell on August 19th. But the rules governing a referendum—which he would almost certainly lose—are only now being discussed by the CNE, and the draft of them, just unveiled, is cumbersome and excessively bureaucratic. “This is a long-distance steeplechase,” said one opposition legislator, “and it's the government that's putting up the hurdles.” The question is whether the CNE will help it, or not.

One straw in the wind is the attitude of most of the CNE's members to Sumate, a non-profit group that was formed to help Venezuelans claim their constitutional rights and, in this case, to get signatures. Sumate's 10,000 volunteers gathered more than 3m of them, and are now preparing to start all over again. The group insists that it is non-partisan; the government says it is a private company, run by yuppies, that falsely claims to represent the electorate. It wants to take Sumate to court, thereby forcing the distrusted political parties, not civil society in general, to request a referendum if there is to be one at all. And the CNE majority agrees.

If the referendum door closes, unrest is bound to grow. But Mr Chávez remains comfortably in charge, not least of the airwaves. During one recent, two-hour broadcast he treated viewers (and listeners) to a literacy class, featuring himself as the teacher. His efforts were marred by his failure to spell *adquirir*, “to acquire”. The minister of education, sitting among the pupils, bravely put him right.

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Cuba's economy

Nickel, but no dimes

Sep 18th 2003 | HAVANA
From The Economist print edition

Few takers for Castro's minerals

Get article background

THE timing was awful. Last April, Marcos Portal, Cuba's basic industries minister, trailed round Europe seeking funds to develop the island's vast nickel reserves. Before setting off, as a member of Cuba's Council of State, Mr Portal had voted to execute three hijackers who had seized a ferry in a bid to reach the United States. The executions, and the jailing of dozens of democracy activists, plunged relations between Cuba's Communist government and the European Union into acrimony. Mr Portal was received politely, but returned with nothing substantial.

Nickel is a potential bonanza for Cuba. Exports of nickel and cobalt totalled $600m last year, more than sugar. The island is the world's sixth-biggest nickel producer and holds 30% of the world's reserves of the metal, used in stainless steel and other alloys. The United States is a big nickel-importer, and Cuba's natural market; but the trade embargo means that American firms can do no more than sniff around. So Europe takes three-quarters of Cuba's nickel. Canada's Sherritt International and various European banks have invested $400m in one nickel-concentrate plant, run as a joint venture, and in two state-run plants. Output at the plants has tripled, but investors have balked at building costly new facilities.

That means that Cuba will find it hard to take advantage of current high prices for nickel. The government wants to boost output, from 75,200 tonnes last year to 100,000 tonnes by 2007 and 150,000 tonnes within 15 years, by enlarging the plants. But that would cost $1.2 billion. European diplomats say little of the money has been secured. Several potential investors have come, looked, and gone again. Australia's Western Mining reneged on a plan to build a $1 billion nickel plant and refinery. An unfinished plant for ferro-nickel at Las Camariocas has been mothballed since the collapse of the Soviet Union, Cuba's former sponsor. BHP Billiton, an Anglo-Australian group, has completed a study of a 300m-tonne deposit at San Felipe in central Cuba, but is in no hurry to invest the $1 billion needed to develop it.

So Cuban officials have looked elsewhere. In January, Cubaniquel signed a supply agreement with China's state-owned mining firm, together with letters of intent for investment of $34m in nickel projects. But nothing may result; even the Chinese are wary of Cuba nowadays.

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India's economy

Ready to roll (again)?

Sep 18th 2003 | DELHI AND MUMBAI
From The Economist print edition

Panos

A setback for reform takes some of the shine off a glowing economy

Get article background

ARUN SHOURIE, India's minister for disinvestment (the preferred Indian euphemism for privatisation), did not conceal his frustration at a Supreme Court judgment on September 16th. Collared by the press on a visit to Berlin, he lamented that the ruling, which scuppers for the time being the privatisation of two state-owned oil companies, was “a major setback with huge consequences”.

The court ruled that the sales required explicit parliamentary approval, which the government cannot be certain of securing. These sales were the centrepiece of its privatisation plans for this year (as they were, in fact, last year), and the ruling will also affect some other asset sales. Worse, it helps foster the impression that the system has an institutional bias against economic reform. “This is the difference between India and China,” complained Mr Shourie. “In India everybody has a veto.”

India can do without this sort of publicity. The world is—once again—waking up to its enormous economic potential. According to the finance minister, Jaswant Singh, “fundamentals today are so encouragingly better than ever before.”

Mr Singh goes a bit far. But because of a confluence of benign trends, economic optimism abounds. India's GDP is expected to grow by at least 6% this year, thanks partly to demand from a more robust global economy, and, more importantly, to the most bountiful monsoon for many years. Almost half of India's GDP still comes from the countryside.

A stockmarket surge has been barely dented by the Supreme Court ruling or even, for more than a few hours, by the deadly terrorist bombings in Mumbai last month. Earlier this month, the index covering the Mumbai exchange touched levels not seen since February 2001, having climbed by more than 50% since April. Profits of companies included in the index were up by an estimated 50% in the second quarter of 2003, compared with the same period in 2002.

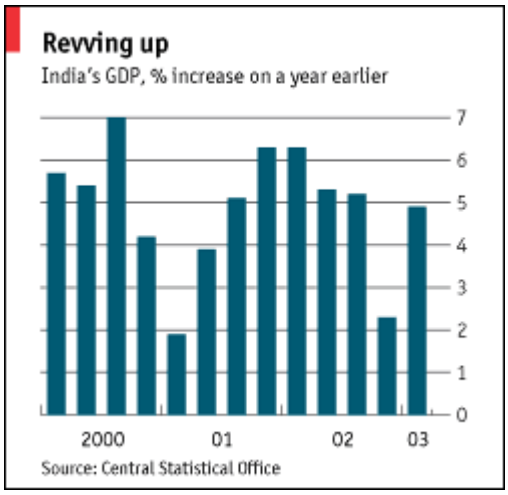
True optimists look far beyond the stockmarket. Painful reform and restructuring in the 1990s, they say, is paying off. Shorn of the protections and blandishments of what became known as the “licence raj”, and more open to foreign imports, India is now producing companies that can compete with any in the world. These include not just the well-known successes in information technology and pharmaceuticals, but also businesses in “old economy” industries: cars and car parts, motor-cycles, cement and steel.

In 2002, a subdued year for the world economy, India's exports grew by 19.2%, a rate beaten only by China, whose currency, Indian exporters point out, is notoriously undervalued, whereas the rupee has, unusually, been appreciating against the dollar. However, India's is still, in global terms, an economy that has a long way to go before it looks very much like a tiger. Last year it accounted for just 0.8% of world exports.

It is true that many Indian firms are exhibiting new signs of self-confidence. Indeed, China itself, long seen by Indian businesses as a threat, is now seen by some as an opportunity. The success there of Indian steelmakers, to take an old economy example, has been such that they have been exceeding the quantitative quota (3% of steel imports) that China imposes on them.

Asked to explain the rosier outlook, manufacturers cite one factor above all: the sharp decline in interest rates—from an annual rate of roughly 12% to half that—in the past five years. Besides beautifying company balance sheets, this is encouraging consumers to borrow, to buy cars, for example, and build houses.

In the past, economists worried about private-sector borrowers being “crowded out” in India by the massive financing requirements of the central and state governments—which account for some 10% of GDP. This squeeze has recently been quite mild, partly because of the high rate of private savings, but also because demand for credit has been relatively subdued. Now some are asking what might happen if this should change.



As Rakesh Mohan, deputy governor of the Reserve Bank of India, the central bank, points out, the rising stockmarket and much lower interest rates have presented Indian companies with a hugely reduced cost of capital. That, combined with their juicy recent profits, would be expected to give a big boost to capital spending. Mr Singh, the finance minister, is yet to detect signs of one. He complains that Indian businesses and banks—even the state-owned ones—are sitting on fortunes in cash and government bonds.

He dismisses concerns raised by the privatisation morass about the uncertainty of policy, but concedes that “bureaucratic slack” does complicate implementation and deter investment. So do infrastructural shortcomings, restrictive land and labour laws, and a wait-and-see approach by businesses expecting cuts in import duties.

If India's economy really is approaching take-off, an investment boom should be just around the corner. Money is coming in from abroad, but more readily in the form of portfolio than direct investment. Ways need to be found to exploit those domestic pots of gold. If that happens too successfully, though, another worry will loom: that the demand for capital could undermine a central pillar of the present optimism—cheaper credit.

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Communal violence in India

The massacre at Best Bakery

Sep 18th 2003 | DELHI
From The Economist print edition

A rebuke for the state of Gujarat

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AFP

Modi rapped

BESIDES throwing a spanner in the privatisation works, India's Supreme Court intervened this month on even weightier matters: the dangers of impunity, the legitimacy of the government in one of India's most prosperous states, and the integrity of the judicial system itself. It did so in the form of a stinging reprimand for the Gujarat government's failure to bring to justice a single murderer after a pogrom last year in which as many as 2,000 Muslims were killed.

On September 19th, Gujarat's police chief and top civil servant were due to appear before the court. They were to be asked to show that the state is serious about prosecuting 21 Hindus accused of burning 14 Muslims to death in the Best Bakery in the town of Vadodara on March 1st last year. The accused were acquitted after almost 40 witnesses withdrew their evidence. Suspicions of intimidation were further strengthened when Zaheera Sheikh, an 18-year-old witness, said that, out of fear, she had lied under oath.

India's National Human Rights Commission petitioned the Supreme Court, asking for a retrial in another state. Apparently to forestall this, the prosecution in Gujarat appealed against the acquittals. They did it so amateurishly, however, as to enrage the Supreme Court. On September 12th it told the government that the appeal was eyewash, and that it should resign if it was incapable of prosecuting the guilty.

Human-rights activists, however, will not celebrate until the Supreme Court orders a retrial outside Gujarat, ending what T.R. Andhyarujina, a legal counsel for the commission, calls the prevailing climate of intimidation, insecurity and tension for the witnesses.

Many will enjoy the discomfiture of Narendra Modi, Gujarat's chief minister. He once described the Best Bakery case as part of an effort to block the state's path of progress by exaggerating stray incidents. However, reviled by liberals even within his own ruling Bharatiya Janata Party, Mr Modi seems to enjoy being an object of loathing. He won an election last December, partly by portraying himself, his government and India's Hindu majority as victims of a pro-western, pro-Muslim establishment. Mr Modi can now add India's highest court to his list of imagined foes.

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China and North Korea

Preparing for the worst

Sep 18th 2003 | BEIJING
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China may be gearing up to deal with a Korean crisis

CHINA is beefing up its military presence on the border with North Korea. Its foreign ministry has tried to play down recent deployments, saying they are simply part of a long-planned handover of border duty from the police to the army. But diplomats believe China is also sending a signal that it is preparing to deal with a crisis arising from North Korea's illicit nuclear weapons programme.

They say that large convoys of infantry have been seen moving in broad daylight through the area during the past couple of weeks. The soldiers are believed to be from the Shenyang military region, which covers the whole of north-eastern China, including the 870-mile (1,400km) border with North Korea. Large-scale deployments near the border are highly unusual. The Shenyang military region has traditionally focused on defending the border with Russia to the north and east, rather than North Korea to the south.

Hong Kong reports put the numbers involved at around 150,000 troops. That would be about 60% of the military region's dwindling strength. The improvement of China's ties with Russia has made Shenyang a particular target for troop reductions (China announced this month that its armed forces would be trimmed by another 200,000 by 2005, though at 2.3m they would remain the world's biggest, and with a fast growing budget). Diplomats say the Shenyang military region's attention is now increasingly focused on potential security problems arising from the Korean peninsula.

China denies there has been any massing of its forces. A foreign-ministry spokesman said that, from the beginning of September, soldiers began taking over guard duty from police along the borders both with North Korea and Myanmar as part of a “normal adjustment”. The purpose was to bring border management in the two areas into line with arrangements elsewhere on China's periphery. This had been discussed for many years, he said.

But if so, why proceed just now? Both China and North Korea like to use symbolism in their relations with other countries, especially communist ones. China's movement of troops near the border may have been meant to be conspicuous, since they could easily have moved at night. Chinese officials privately express fears about the impact on the north-east of any large-scale influx of refugees that might be triggered by conflict or unrest in North Korea.

If North Korea ever does fall apart, a likely cause would be economic pressure. Such pressure would have to involve China, which is a vital source of North Korea's fuel and food. Could China be signalling that if North Korea doesn't abandon its nuclear programme, sanctions might follow? The secretiveness of China's armed forces, and the lack of communication, not to mention downright frostiness, between them and their American counterparts hugely complicates any scenario involving North Korea's sudden collapse and the possible intervention of American or Chinese troops. “The situation in the Korean peninsula is a clarion call for some form of dialogue [with China],” says Kurt Campbell, a former senior Pentagon official responsible for Asia-Pacific affairs.

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Counter-proliferation

Practising to provoke

Sep 18th 2003
From The Economist print edition

Interrupting the trade in illicit weapons technologies

AP

Dropping in for a chat

IT IS not often that Australia, France, Japan and America find themselves out on military manoeuvres together. For three days this week their ships and aircraft gathered in the Coral Sea off Australia's Queensland coast for Operation Pacific Protector to rehearse the tracking and boarding of ships suspected of carrying cargoes that could be used in making weapons of mass destruction. Nothing but a "provocation", fumed North Korea, whose proliferation activities—selling drugs, counterfeit dollars and missiles in order to finance imports of technology and equipment for its nuclear, chemical or biological weapons—make it a prime target for such stop-and-search tactics.

But not the only one. The 11 countries (the others are Britain, Germany, Italy, the Netherlands, Poland, Portugal and Spain) that launched the "proliferation security initiative" earlier this year, to help curb the trade in illicit materials, will be swapping information on dodgy shipments to and from any country "of proliferation concern". There is no formal list. But Iran (in hot water with UN inspectors over its nuclear dabblings), Syria, Libya, Pakistan and others with extensive weapons-trade connections can expect closer scrutiny.

More naval exercises are planned, including in the Mediterranean. Britain will host a command-post exercise to practise ways of blocking suspect air shipments. Guidelines for international action were hatched at a recent meeting in Paris; another next month in London will try to decide how best to get others to help.

Firms in Russia and China used to be the preferred sources of illicit weapons technologies. Now those building such weapons or the missiles to deliver them have set up supply networks among themselves. Disrupting these will need co-operation from governments along trans-shipment routes, for example through Central Asia, and in places such as Hong Kong, Singapore, Oman, Egypt and Turkey. Under existing international law, even a ship on the high seas can be stopped, but only so long as the flagging country agrees.

At the International Maritime Organisation there is discussion of adding shipment of weapons of mass destruction to the other activities already banned at sea. Eventually the UN Security Council may be asked to endorse new restrictions on trade in certain goods and technologies. But for now the emphasis is on tightening existing laws and enforcing them more rigorously. North Korea, for example, finding its

ships under uncomfortably close watch, is now thought to rely more on air routes across China to the Middle East to ply its weapons-related trade. Blocking such flights could be a way for China to press North Korea to give up its nuclear ambitions. Don't rule it out.

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Japan

The end of donor fatigue?

Sep 18th 2003 | TOKYO
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Japan's big-business lobby ponders a return to money politics

THEY may not be accountable, but in one way, at least, Japan's political parties have been suffering along with the rest of the country. Political donations plummeted in the 1990s, due to a weak economy and a series of scandals that caused corporate donors to shy away. In 2002, according to figures released by the home-affairs ministry last week, donations from businesses and other organisations fell to only ¥3.7 billion ($29.5m): down 18.8% from the previous year, and less than a tenth of their level when the bubble collapsed. Now, however, Japan's main business federation, the Nippon Keidanren, is considering ways to restore some of its lost political clout.

The Keidanren (which expanded its name to Nippon Keidanren after merging with another federation last year) got out of money politics in 1993. After the cold war ended, Japan's political parties fragmented, and big corporations no longer faced a clear choice between the pro-business Liberal Democratic Party (LDP) and an anti-business opposition, a stand-off that had dominated Japanese politics since 1955. Keidanren members' political interests diverged, and a scandal-ridden climate made giving money to politicians trickier still. The Keidanren chose to stop pooling campaign donations from its members on behalf of the LDP, and left businesses to make their own decisions.

Those firms increasingly decided to stop investing money in politics, at least by means of donations to parties and political campaigns. Although the home-affairs ministry oddly provides records only back to 1998, the *Mainichi* daily newspaper says donations peaked at ¥44.7 billion in 1990. By 1998 they had fallen by nearly two-thirds, to ¥15.3 billion, and they have continued to drop sharply. Lately, however, the Nippon Keidanren has been looking for ways to regain some of its influence.

Its chief, Hiroshi Okuda, who is also the chairman of Toyota, is especially keen for the federation to start giving money again. His own company was Japan's biggest corporate political donor last year, giving ¥64m to the LDP. One of the most immediate rewards that Mr Okuda and his fellows hope to gain is a corporate tax cut, an idea the prime minister, Junichiro Koizumi, has already backed. The Nippon Keidanren has also urged a cap on pension premiums, half of which are paid by employers.

Besides just trying to raise more money, the Nippon Keidanren also wants to boost research on policy. The big political parties have recently begun experimenting with more detailed political platforms, and hope to use these in the next general election, expected in November. If it can crank out some policy proposals of its own, the business group might gain a greater say in the debate. If things go really well, it might even regain enough influence to spark a scandal or two.

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Laos

The phantom menace

Sep 18th 2003 | VIENTIANE
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Myth and reality in Indochina

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TO READ what little news emerges from secretive Laos, you would think one of the world's last communist regimes was on the verge of collapse. The biggest investment scheme in Laotian history appears to have fallen through. Mysterious assailants have been launching attacks on highways all over the country. A long-forgotten insurgency is making headlines again. A bomb exploded last month in the centre of the capital, Vientiane. Laotian exiles in America have announced the beginning of a revolution. The contrast with recent years, when relative calm propelled foreign aid and tourism to record highs, is stark—and, it turns out, misleading.

In fact, Laos has had a long history of security problems. Supporters of the royalist regime that was overthrown in 1975 have maintained a sporadic rebellion. In 2000, a series of bombs exploded in Vientiane, while Laotian émigrés staged an attack on a frontier post from neighbouring Thailand. And it is anyway easy to exaggerate the scale of the problem. The remaining insurgents, most of them descended from ethnic Hmong recruited by America to fight the North Vietnamese, number no more than 3,000. They have featured in the news recently because a few journalists have made it to their last mountain hideouts (and been arrested by the authorities for doing so). But the journalists described the rebels as a bedraggled lot, constantly harried by the army and desperately short of arms, ammunition and food.

Nor is there much sign of the uprising announced in July by the “Lao Citizen Movement for Democracy”. At the most, foreign diplomats in Vientiane say, small bands of fighters have been taking pot-shots at the odd guard post or army truck. There is little sign of military activity in many of the supposed battle zones, nor any sense of alarm in the big cities. One theory holds that émigré groups have launched a phony rebellion in an effort to disguise their weakness.

Attacks on the roads are equally inconsequential, if more bloodthirsty. They consist of little more than gunmen strafing passing buses. The bomb in Vientiane, meanwhile, was a home-made device that injured only 10 people, despite exploding in the city's main market.

Since the government does not tolerate any political opposition or independent media, it is difficult to know what ordinary Laotians think about all this. But it probably would not occur to the subsistence farmers who make up the majority of the population to protest in the first place. The rebels in the mountains aside, the government treats the Hmong no worse than it does the rest of Laos' myriad ethnic groups. Those who chafe at the government's strictures can simply slip across the Mekong river to Thailand.

In fact, foreigners are more likely to undermine Laos's stability than locals. The economy's recent growth stems in large part from tourists, whose numbers have swelled from 146,000 in 1994 to 735,000 in 2002, and foreign aid, which peaked at over $57 per head in 1999, one of the highest figures in the world. This year, tourism has declined sharply, thanks to the war in Iraq and the outbreak of the respiratory disease SARS,as well as Laos's own security problems. Foreign aid is also plunging, as countries like Iraq and Afghanistan claim more attention, and dissatisfaction with Laos's human-rights record grows. Japan, Laos's biggest benefactor, this year pledged only a third of what it gave last year.

Denmark recently called off its aid programme altogether. What with France's state-owned electricity company pulling out of a huge project to build a hydropower plant on one of the tributaries of the Mekong, it looks like the regime's biggest problems lie overseas.

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The Philippines

A prince among clerics

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From The Economist print edition

Cardinal Sin retires

ALTHOUGH church and state are formally separated in the Philippines, in reality they are inseparable. Cardinal Jaime Sin has been their unifier. In a statement this week to mark his retirement at the age of 75, the cardinal said that he had given his “very best to God and country”. Combining the spiritual and the temporal: that has been the cardinal's mission.

His finest hour was in 1986. Ferdinand Marcos, who for years had run the country as a dictator, was presumed to have lost a presidential election but refused to go. The cardinal, using his authority as head of the Roman Catholic church in the Philippines, urged the people to take to the streets of Manila in protest. A shaken Marcos was in due course flown out of the country by the Americans, and his presidential rival, Corazón Aquino, became president. In 2001 the cardinal again supported “people power” to depose President Joseph Estrada, because he had “lost his moral ascendancy to govern.”

The cardinal, whose father was Chinese and mother part Spanish, grew up to be aware of the dominance of rich families in a poor country. He has sought to show his flock of some 65m that the church is as caring as the communists who also woo them. Most ambitious politicians have sought the blessing of the “prince”. His successor as head of the church in the Philippines is Archbishop Gaudencio Rosales. Supporters of the church militant note that he gained prominence in the 1980s speaking against illegal loggers.

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Yasser Arafat under threat

But it's not time yet to kiss good-bye

Sep 18th 2003 | JERUSALEM
From The Economist print edition

AP

Israel's decision in principle to “remove” Yasser Arafat marks a new danger

Get article background

PRESSURE from America has persuaded the Israeli government not to go ahead with its plans to deport Yasser Arafat. For the moment, that is. It has also checked its plans to drive the security wall deep into Palestinian territory, though, again, a cabinet meeting to decide the route of the wall has been merely postponed. Everything could change with a new wave of bombings, sweeping aside Ariel Sharon's concerns for America's reservations.

Mr Sharon and his ministers regularly, and often with impunity, turn a deaf ear to American remonstrations, particularly over the settlements, where, under the terms of the road map for peace in the Middle East, all new building should be frozen. American reminders this week that money spent on settlement-building will be pared from loan guarantees had no effect on the busy building that goes on.

Silvan Shalom, Israel's foreign minister, told European Union diplomats this week that Israel would not be taking immediate steps against Mr Arafat, and that calls by some ministers to kill him were not official government policy. This followed a cabinet move on September 11th deciding to “remove” Mr Arafat, and a later statement by Ehud Olmert, the deputy prime minister, that killing him was an option. The chief of Shin Bet, the internal security service, has also let it be known that he favours assassination. Israel holds the Palestinian president responsible, at least obliquely, for a new surge in terrorism, and for the collapse of the short-lived government of Mahmoud Abbas.

The American administration also sees Mr Arafat as an obstacle to progress, but fears that his forcible removal would escalate violence and cause huge anger in the Arab world. The cabinet's decision-in-principle triggered a wave of demonstrations throughout the Palestinian territories, and stern warnings to Israel from foreign governments to leave him be. On September 16th, the Americans vetoed a UN Security Council resolution to this effect, because it did not explicitly condemn Palestinian terror groups.

For Palestinians, the Israeli debate over whether to expel or kill their elected leader is theoretical. Expulsion means death, they say. “If soldiers were to enter his office, he'd reach for his pistol,” says an aide who was with Mr Arafat during his earlier expulsions from Jordan and Lebanon. “He won't be exiled again.”

So what would follow if Mr Arafat were to go out in a blaze of martyrdom? It could well mean the dissolution of what remains of the Palestinian Authority (PA). Some members of the authority believe this could have advantages.“What is unacceptable is the present situation, where Israel has military control over us but we are expected to run the schools and crack down on the opposition,” remarked one minister. “This suits Sharon like a glove. It's not going to continue.”

Full-fledged occupation would mean not only martial rule over the 3.5m Palestinians in the West Bank and Gaza, but that Israel would also be responsible for their welfare. This led to resistance in the past, and it would do so again, said the minister, but compounded by the fact that this time the Palestinians have weapons, and some 30,000 armed policemen.

But it would be even worse, said a Palestinian official, for the authority to try to stagger on, with many different forces fighting to fill the vast hole left by Mr Arafat. This could lead not only to violence against Israel, but also to an intra-Palestinian struggle, with Fatah's young guns competing against the PA's older ones.

In a bid to avert either disaster, the Palestinians have come up with the offer of a new ceasefire. On September 16th, Mr Arafat's newly appointed security adviser, Jibril Rajoub, offered a “comprehensive and unlimited Palestinian ceasefire”. Unlike the unilateral truce that went up in flames with the Hamas bus bombing in Jerusalem last month, this one would be mutual: the Palestinians would end all acts of violence in return for Israel ending its assassinations of Palestinian militants, and lifting the blockades that cripple Palestinian life throughout the occupied territories. Hamas is said to be on board, but Israel dismissed the suggestion out of hand.

Luxuriating again in the warmth of his people's support, and in being once more at the centre of affairs, Mr Arafat is said to be confident that Israel will not act on its decision to remove him, so long as America says no. His supporters are less easy in their minds. They know from experience that what the American administration prohibits one day, it may permit the next. They are waiting for the next assassination, and the next suicide bombing.

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Iraq's Kurds

Can Kurds and Arabs be reunited?

Sep 18th 2003 | IRBIL
From The Economist print edition

Kurdish doubts about reintegration

Reuters

Will Kurdish fighters be welcome in Basra?

ALTHOUGH basking this week in a visit from Colin Powell, America's secretary of state, who promised that they would not be abandoned, Iraqi Kurds are beginning to question the future. America's victory could even achieve what 35 years of Saddam Hussein's rule failed to do: reintegrate the north back into Iraq.

Ever since their northern safe haven was set up in 1991, the Kurds have run their own affairs. They flew their flag over the territory they call Kurdistan, circulated their own money, and cleansed themselves of Arab influence. Now the Kurds, who alone greeted the American invasion with flowers, are being ordered to unify.

In recent weeks, they have been told to take down their flag, and begin the merger of their *peshmerga* guerrilla forces into a national army and police force. Their currency is being withdrawn. Less seriously, they are also threatened with an Arab invasion, albeit of tourists, not soldiers. Busloads of Baghdadis are flooding to the mountains on package tours that offer relief from the insecurity and the heat, and the chance to reclaim hills that have been out-of-bounds for the past dozen years.

Kurds, displaced in their hundreds of thousands by Saddam's programme of Arabisation, now wait on Arab pleasure-seekers blasting Arab pop music over Kurdish hills. Arab businessmen will follow. Communication is complicated by the lack of a common tongue. Elderly Kurds are polishing their Arabic, but since 1992, Kurdish schools have taught no Arabic to children under ten. Despite appeals from Baghdad, the Kurdish minister refuses to budge. A generation of Kurds can barely construct a sentence in Arabic, which bodes ill for those seeking to create a representative civil service in Baghdad.

Financially, unification is proving bitter. The Americans have already banned the collection of tolls at checkpoints and borders, hitherto a prime source of revenue, and curtailed the oil smuggling to Turkey, on which the Kurds got a handsome cut. Salaries will be paid from Baghdad. And though there has been toing and froing on the issue, it now appears that the Kurds' old currency, known as the “Swiss dinar”, will be invalid come January.

The oil-for-food programme, under which the Kurds were guaranteed 13% of Iraq's oil revenue, is to cease on November 21st, and the unspent billions will go to Baghdad for reallocation. To sweeten this disappointment, America is handing the Kurds the UN's oil-for-food assets in the north: the banks of cars, computers, power plants and installations are valued at billions of dollars. The Kurds have also submitted their own $2.4 billion project budget for 2004, which they hope will be financed from unspent oil-for-food funds.

But the largesse will be one-off. In the years ahead, the Kurds will have to compete with the rest of Iraq for resources, and the budget will come from Baghdad, says Stephen Mann, the Coalition Authority's financial adviser in the north.

And, for all their past praise of the *peshmergas*, the Americans are planning to merge the militias into Iraq's national army. This means that Kurds may go to Basra, but it also means that Arab troops may be back in the north. Checkpoints, disbanded after the war to ease freedom of movement, are back after the bombing of an American intelligence station in Irbil, but the Americans want them manned by the national police, not by Kurdish militias.

Will the Kurds resist? The Iraqi flag is still nowhere to be seen in the north, and the Kurds, says the regional education minister, still aspire to their own state, albeit not for now. The instability to the south has strengthened the voice of those arguing for a return to the pre-war status quo when the Kurds ruled themselves. On his office wall, a *peshmerga* commander traces progress on a map of Kurdistan that stretches in an arc from halfway down the Syrian border to south of Baghdad. He demands self-determination for the 3m Kurds: “Democracy does not mean that Arabs should decide the fate of the Kurds.”

But, for all their claims, the Kurds are proving remarkably practical. Families, flocking south to reclaim homes from cities where Saddam Hussein had settled Arabs, are waging their property disputes with law suits rather than guns. In fields west of Kirkuk, returning Kurdish farmers agreed to share this year's harvest with fleeing Arabs. Many Kurds also relish the prospect of rejoining over a million of their brethren in Baghdad and Mosul.

Moreover, America's ethnic carve-up of government posts has given the Kurds a strong stake at the centre. The five ministries run by Kurds include water, Iraq's second most valuable resource, and foreign affairs. A Kurd heads the committee that has the prickly task of preparing the path to a new constitution. The battle has barely begun. As a minimum, Kurds see a federal future, in which Kurdish turf embraces oil-rich Kirkuk, and has Kurdish as its official language. With Iraq's Shia majority so divided, they hope to get their way.

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Iraq's Turkomen

Looking for Turkish protection

Sep 18th 2003 | KIRKUK
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A small minority with a big friend

TURKISH television networks did not think much of Colin Powell hobnobbing with the Kurds. Instead, they chose a more quirky story to lead their bulletins: the congress of the Iraqi Turkomen Front in contested Kirkuk. The front, claiming to speak for the vastly inflated figure of 3m Turkomen, paraded photos of martyrs they say were killed in a post-war Kurdish push for *Lebensraum*. It seeks a strong, united Iraq and vows to keep Kirkuk, "the Turkomen heartland", out of Kurdish hands.

The 500-strong congress ousted its president, who had opposed foreign troops in Iraq, and called on Turkey to be its protector. As well as providing money, Turkey supplied the congress with military liaison, a horde of journalists and a letter from the Turkish foreign minister, Abdullah Gul. If the Kurds promote the prospects of pan-Kurdish unity, say the Turkomen, why should not the Turks promote their own interests?

American army officers detained Turkish soldiers escorting Turkomen to the gathering. But they fear their efforts could soon be overturned by their superiors, who look for Turkish help in quelling the Sunni Arab rebellion west of Baghdad. Bringing in troops from neighbouring states will exacerbate tensions, admit the Americans, but they are not spoilt for choice.

If Turkish forces enter northern Iraq, the Kurds vow to return to arms. But, in fact, the Turks are not coming; they are there already. For years, Turkey has deployed troops in northern Iraq, and has some 40 tanks dug in up to 40km (25 miles) over the border. It has military liaison offices in all the main Kurdish cities, including Kirkuk; and some 100 Turkish officers train 250 local Turkomen in a garrison looming over the heart of Irbil. Asked to leave last May by the Kurdish regional government, Turkey repainted its barracks the colours of the Turkomen flag.

Yet, for all the foreign hands, Kirkuk still feels uncommonly relaxed. A multi-ethnic police force is being trained, to reduce the Kurdish share of policemen to 40%. And polyglot locals flick dice in the cafés unfazed, mixing Turkomen, Kurdish and Arabic in the same sentence.

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Iraq at the United Nations

Who is to have the final say?

Sep 18th 2003
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The question is whether the Americans or the Iraqis take the decisions

Get article background

IF THE French and Germans at the UN Security Council have their way, there will be little left of the draft resolution on Iraq that America presented on September 4th—or, indeed, of America's role in post-war Iraq, except for security. That won't happen, of course. The two governments are meeting America's ally, Britain, in Berlin on September 20th to try to work out a common position. But it is also difficult, at least at this point, to see such a position emerging.

Basically, the French and Germans want the Americans to hurry up and cede all civilian control to the Iraqi interim administration, the Governing Council. The council would then have the final say, with help from the UN, on such crucial matters as oil revenues, aid and the move to democracy. The American-run Coalition Provisional Authority (CPA) would be out of the picture.

If the Americans reject these suggestions, the French are unlikely to veto the resolution. But then, they and several other well-off countries may not respond to the resolution's call for international aid for Iraq's reconstruction.

Resolution 1483, passed last May, gave the CPA control over everything. The draft American resolution would keep this control, though it allows the UN “a vital role”, including the authorisation of a multinational force under unified command, and calls for international financial assistance. America's critics worry that this force would be separate from the coalition's own troops.

On reconstruction, the French-German proposals want the Governing Council to be in charge soon, though it would still turn to, say, the World Bank for help. To this end, they ask the coalition to provide a plan of action, and a timetable, for handing civilian administration to the council. They call on the coalition to step aside, partly to bolster Iraqi independence, partly because of the suspicion that American companies stand to gain from reconstruction.

The American draft resolution invites the Governing Council to provide, in co-operation with the CPA and the UN, a timetable and programme for drafting a new constitution and holding elections. The French-German amendments agree to such a timetable, but also want a timetable for the coalition to hand over decision-making speedily to the council.

All this is strong stuff. But the French and Germans argue that, unless the CPA recuses itself, the Governing Council will continue to be plagued by legitimacy problems, and to be seen by many Iraqis (and other Arabs) as little more than an American puppet. This is a point that some of the council's members, including some of America's strongest political allies, have leapt on, arguing that there should be a quick end to America's civilian control, and a speedy handing over of power to themselves.

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Iran's nuclear diplomacy

It's all gone dreadfully wrong

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Even the European Union has lost patience with Iran

WHEN confronted with difficult questions about its nuclear programme, Iran's strategy has been to play for time. That approach backfired badly last week when the International Atomic Energy Agency (IAEA) expressed its collective exasperation with Iran's evasive attitude. Instead of buying more time, Iran now faces a deadline of October 31st to dispel doubts about its nuclear ambitions.

When the 34 other members of the IAEA's governing board adopted a strongly-worded resolution, Iran's representative, Ali Akbar Salehi, walked out of the proceedings in anger. He should not have been surprised. Concern over Iran's nuclear activities has been mounting on both sides of the Atlantic. France and Germany share American suspicions about the nature of Iran's programme, and the European Union has presented a united front to the government in Tehran. But Iran mistakenly pinned its hopes on non-aligned governments blocking an American-backed resolution.

The result was a diplomatic disaster for a country that has made a priority of courting Europe as a buffer against America. Muhammad Khatami's reformist government counted the improved relations with European governments as one of its few successes. But the nuclear issue has exposed the limits of its authority.

Mr Khatami's supporters pleaded with the EU to tread softly to avoid giving ammunition to their hardline opponents in the theocratic system. But there is little sign that the reformists have the final say on the issues that matter to the rest of the world, and the gap between Iran's words and actions could no longer be overlooked.

Even the staunchest advocates of talking to Iran, such as Jack Straw, Britain's foreign secretary, are forced to question the fruits of “constructive engagement”. Mr Straw has an extra little difficulty: the four successive sets of pot-shots at the British embassy in Tehran. Nobody was injured in the attacks and nobody has been arrested. The government calls them “isolated incidents”, though in every case the shots were fired from a passing motorcycle.

Iran has played its cards badly. Some reformists in parliament point out that it would have been much easier to defuse the nuclear issue months ago, simply by taking the initiative and signing up for short-notice inspections. Now, saving face will be much harder. With France standing side-by-side with the Bush administration, Iran has managed to produce the seemingly unattainable: transatlantic unity.

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Zimbabwe's continuing descent

Shut up, unless you fawn

Sep 18th 2003 | HARARE
From The Economist print edition

Gloom in Mugabeland

AP

Alas, no longer

MOST Zimbabwean papers either fawn over the regime or severely censor their criticism. The *Daily News* was an exception: recently it dared to report that Robert Mugabe was building himself a palace outside Harare. But on September 12th, the police marched into the newspaper's offices, chased out the staff at gunpoint and tried to arrest the editor, who had refused to register under a draconian media law passed last year. After a judge, known to be a friend of Mr Mugabe's, ruled last week that the law is constitutional, the police pounced.

The *Daily News* has been closed down, and its editor has resigned. It may eventually return, but bruised and weaker. It kept going after its printing presses were blown up three years ago, even though its distributors have been regularly beaten. But the owners now say they will register under the new law. Nobody expects the same robust criticism.

Mr Mugabe faces a price, of sorts: this latest attack on the press has scuppered his plan to attend a meeting of Commonwealth leaders in Nigeria in December. Zimbabwe has been suspended since its rigged presidential election in March 2002, but African leaders had hoped to bring it back into the club. South Africa's Thabo Mbeki had wanted Mr Mugabe rewarded for allowing limited talks about the constitution with the opposition Movement for Democratic Change. But this week, the head of the Commonwealth secretariat said Mr Mugabe would not be welcome.

In truth, there are many other reasons why Commonwealth and European Union sanctions should stay. A show trial continues of the opposition leader, Morgan Tsvangirai, who is accused of treason and could face the death penalty. Police torture goes on: a recent report by a Zimbabwean lobby, Human Rights Forum, lists 390 cases of physical abuse and 473 cases of unlawful arrest in the first seven months of this year.

Even Mr Mugabe's own former secretary, Charles Utete, has produced an (unpublished) audit of the land reform programme that shows corruption and misrule. It apparently names ministers who have snatched farms illegally, and notes that far fewer peasant workers were resettled than was first claimed.

Such misrule means Zimbabwe will remain isolated, without investment, aid or loans. Its economy will continue to collapse: its GDP has shrunk by a third in the past three years; inflation has now surged over 420%; and 70% of the population live in poverty. According to Unicef, at least 5,000 street children roam Harare, rummaging in rubbish and begging.

Economic activity is spluttering to a halt. Every roadside trader in Harare complains that business has evaporated. Lack of bank notes stifles what little trade there might be, and forces people to spend several hours a day hunting for ways to settle bills and buy goods. After hours trying, the only way your correspondent could exchange money was with a group of young toughs in a grimy alley in a run-down corner of the city. Some people are resorting to barter: one Harare office-worker described the hours he spent exchanging 100 bags of sugar for 50 litres of paint.

All this creates anger and private grumbling. Newspapers used to be something of a safety valve. Bits of graffiti appear on the streets, declaring *Zakwana* (enough), though there are not, as yet, many signs of

wider public protest. Mr Mugabe's grip is tight. About 100 people were arrested in Harare on September 17th, after marching for a new constitution and against the closing of the *Daily News*.

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Coup in Guinea-Bissau

Farewell to the red bobble-hat

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Kumba Yala had his chances, but chucked them away

Reuters

Better drinking companion than president

AS SOLDIERS took over the presidential residence in the early hours of September 14th, the main reaction from the people of Guinea-Bissau was “about time too”. Yet Kumba Yala had won the presidency in January 2000, with 72% of the vote, in an election considered fair.

Much hope had been placed in the teacher-turned-politician, who promised to heal this small West African country torn by civil war, and with a messy history of military coups and chronic mismanagement. But Mr Yala managed to squander all that goodwill. His style of government was wilful. Ministers were arbitrarily sacked, and fearsomely scolded. He fought with the judiciary and the media. Public-service salaries went unpaid for months, and schools stayed empty. Subjected to a vote of no confidence last year, Mr Yala simply dissolved parliament.

Foreign donors complained of corruption and erratic shifts in policy. Diplomats acknowledged that Mr Yala could be excellent company, a first-rate mimic, a devoted football fan, an enthusiastic drinker and so on, but they could not take him seriously.

The United Nations, the African Union and various African countries have deplored the coup, saying that such things have no place in modern Africa. But the chorus of outrage is half-hearted: the coup is a fait accompli. The new military administration, headed by General Verissimo Correia Seabra, the chief of staff, is not going to budge.

The general has been here before. Involved in coups against two former presidents, in the 1980s and 1990s, he is part of the generation that fought a long and successful guerrilla war against the Portuguese colonialists. He has promised elections when the time is right, and has held talks with politicians, religious leaders and trade unionists.

General Correia Seabra says he wants to hand over power to “a credible civilian leader”, but that will not be Mr Yala. The fiery demagogue in the red bobble-hat has been told he can stay at home or go abroad if he wants, but there will be no second presidency for him.

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Sweden and the euro

Why they said no

Sep 18th 2003 | STOCKHOLM
From The Economist print edition

The reasons usually given for Swedes' reluctance to adopt the euro are probably wrong. The real ones are more to do with politics than economics

Get article background

IF EVER there was a vote that could have been blown off course by a chance event, it was Sweden's referendum on joining the euro. Just three days before the poll, Anna Lindh, the country's popular and charismatic foreign minister, was stabbed to death in a Stockholm department store. Since she had also been the euro-campaigners' standard-bearer, many expected a late surge of sympathy in favour of a yes. After the murder, for the first time in months, a couple of opinion polls showed the yes camp ahead or level. But the Swedes were not to be emotionally swayed. On September 14th, they voted decisively against joining: 56% said no; 42%, yes. Along with Britain and Denmark, Sweden will continue to stand aside from the European Union's 12 other countries that have abandoned their old currencies.

It has often been argued in Brussels that the Swedes' aversion to the euro has been driven mainly by a general hostility to the EU, by an unfocused sense that their welfare state is threatened by the EU, and by a broad resistance to change, especially among older people. The evidence, however, suggests other reasons.

Voters in the 18-30 bracket voted more heavily against joining the euro than any other age group. The same exit polls that accurately predicted a no to the euro also showed that 60% of voters want Sweden to remain in the EU. Indeed, sentiment towards the Union has actually warmed since Sweden first voted to join in 1994. Asked to list the issues that had mattered most, the antis put the welfare state only fourth. Their two biggest worries were about democracy and sovereignty; national control of interest rates came third.

Swedish voters may have taken note of the voices in Berlin, Paris and Brussels that have long extolled monetary union as a “political project”—a crucial step on the road to political union in Europe. The yes campaign tried to counter concerns about sovereignty with arguments about influence. The leaders of all the biggest parties and of most of Sweden's largest companies argued that the country risked being marginalised in the EU if it shunned the euro. Such arguments resonated with diplomats, international businessmen and the wealthy (Stockholm's richest suburb voted 75% in favour) but did not impress ordinary people, who may wonder how much influence a country of 9m can have in a Union soon to number 450m.

Goran Persson's Social Democratic government had tried other arguments. Fairly late in the campaign, Mr Persson began to argue that the euro helps secure peace in Europe. Many yes voters cited this argument in explaining their choice. But the issue of peace cuts less ice in pacific Sweden, which has fought no war for almost 200 years, than in France or Germany.

The yes campaigners tried, above all, to focus the debate on the economy. But in the event, exit polls suggest that economic issues mattered less than expected. When Sweden voted to join the EU in 1994, its economy was in big trouble. But this year Sweden is forecast to grow at 1.5% against 0.5% for the euro area; Swedish unemployment is at 5.4% compared with 8.9% in the single-currency zone. And the euro area is in a mess over its efforts to enforce fiscal discipline on countries using the single currency (see article).

Mr Persson is probably safe as prime minister. Though in the referendum's aftermath he spoke wistfully of becoming a priest or a forest worker, he seems (on mature reflection) to have decided that he will soldier on as head of government. His most obvious successor, Mrs Lindh, is no longer around. And Mr Persson's dignified handling of her death seems to have deflected much of the criticism of him over the conduct of the referendum.

They've heard it all before

Sweden's foreign-policy establishment, however, is in a stew. It fears that Sweden will now be on the defensive in the negotiations that will begin next month over a constitution for the EU. Without Mrs Lindh, a less experienced minister will have to handle them. And the government is bracing itself to resist demands for a referendum on any new EU constitution too.

Big business is also taken aback. Companies like Ericsson have given warning that, in the long run, foreign investment in Sweden will dip. And some economists fear that the country may forgo a boom in trade within the euro zone. Swedish voters, however, heard all these arguments before the referendum and were plainly unimpressed. As one voter in the far north told Swedish television on election night, “It's too soon to make a decision. Come back in 20 years and ask me again.”

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Baltic referendums

All in to Europe

Sep 18th 2003 | TALLINN
From The Economist print edition

Estonia and Latvia will join Europe, though not without protest

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THE government of Estonia had tried hard to play fair. Alone among the ten countries due to join the European Union next May, it had refused to declare itself officially in favour, preferring to let the people judge. But by June, when almost as many Estonians were against EU membership as for it, virtually everyone from President Arnold Ruutel down decided that fairness had gone far enough, and threw their weight behind the yes campaign. On the streets of Tallinn, large, slick yes posters outnumbered small and tatty no ones by a hundred to one. It worked. In the referendum on September 14th, Estonians voted yes, albeit only by two to one.

That resistance, despite everything, is due both to the crude comparisons that Eurosceptics drew between the European Union and the Soviet Union, to which Estonia belonged for half a century, and to serious worries about what EU rules will do to the economic flexibility and low trade barriers that have helped the country prosper since then. But most Estonians, says Toomas Ilves, a former foreign minister, realised “the sky-rocketing interest rates that would immediately follow a no vote and the envy factor if our neighbours were in and we were out.” Latvia, which on September 20th will be the last of the EU's ten prospective members to hold a referendum, will not buck the trend. Lithuanians gave a huge yes in May.

But the polls also reveal another snag of EU integration. In Estonia, a polling company found that the campaign had not convinced the poorest: both in June and just before the referendum, less than half of them wanted to join. In Latvia, while most citizens favour joining, most non-citizens—about a fifth of the population—would, if they could vote, say no.

These nay-sayers are dominated by ethnic Russians and other Slavs. A legacy of the Soviet occupation during and after the second world war, they have been the biggest losers of the Balts' catch-up with Europe. In Latvia, Russian politicians still stir up resentment over issues like the language exam for citizenship or the law that, from next year, makes all secondary schools teach some of the time in Latvian (all but a handful already do). In Estonia, the capital's Russian quarter and the border towns to the east are strikingly shabby, though nowhere near as bad as immediately across the border in Russia itself.

Since Russia is not joining the EU, the border regions remain backwaters, attracting little investment and EU accession funds. Those are mostly going to projects to help the countries integrate, such as roads to the west. Another set of poor people, small farmers, are equally worried about how they will fare under EU quotas and standards and against the Union's subsidised agro-industry. Little wonder that such people remain unconvinced that joining the EU is a good thing. Now that the Balts are about to attain that long-sought goal, they must make it worthwhile for everyone.

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Central Europe and the European Union

Toughening up

Sep 18th 2003 | KRYNICA, SOUTHERN POLAND
From The Economist print edition

Central Europeans begin to sharpen their elbows for Brussels

Get article background

WHEN President Jacques Chirac told a clutch of central European countries in February that they should have “shut up” instead of backing America in its confrontation with Iraq, his words cut deep. Most of the countries he insulted, including Poland and Hungary, had just been invited to join the European Union in 2004. They were minded to slip in quietly and behave politely to the club's older members while they learnt how the place worked. Mr Chirac changed their minds. If the older members were going to act that way, the new ones would act tough too.

They did just that in Italy earlier this month when EU foreign ministers (including those from the ten countries joining next year) discussed the Union's new draft constitution. The six founders—Belgium, France, Germany, Italy, Luxembourg and the Netherlands—said the draft should be adopted, more or less as it stood, by the end of the year. Other EU members, including Ireland, Finland and Austria, were mildly unhappy. But the toughest criticism came from Poland, not even a member yet, with the other central Europeans close behind. “Nobody can limit our right to defend our position,” said Poland's foreign minister, Wlodzimierz Cimoszewicz.

The new members, and some smaller countries already inside the EU, think that the draft constitution favours the Union's biggest countries, mainly France and Germany. To correct that, they want every country, however small, to go on nominating a full voting member to the European Commission, the EU's executive body, even when the EU has 25 members and more. They reject the draft constitution's proposal to cap the number of voting commissioners at 15, plus ten non-voting ones.

Poland, backed by Spain, also wants to block proposed changes to voting procedures in the EU's Council of Ministers, where governments decide on new laws. It wants to keep the existing system of weighted voting which favours small and medium-sized countries, so that Poland will have almost as many votes as Germany, though only half the population. The draft constitution proposes a simpler system whereby a simple majority of countries can carry a vote if they account for at least 60% of the EU's population.

Worryingly for the central Europeans, this rift over the constitution pits them against Germany, their biggest trading partner and their ally in the past, which wants the draft constitution adopted intact. Joschka Fischer, the German foreign minister, has reportedly fingered “a number of financially weak accession countries” as the constitution's main critics—a hint that Germany could use its financial muscle to get the sort of EU it wants.

But a more combative atmosphere in the EU may yet be a good thing if it leads the new members to toughen themselves up, economically and politically. How to do those things was one main theme of the recent annual Polish Economic Forum in the ski-town of Krynica.

The talk there showed that central Europeans have more confidence in their economic competitiveness than in their political readiness. Though poor, they reckon they have more flexible economies and more growth potential than their neighbours to the west. They are keen to adopt the euro, the EU's common currency, though they see that they may have to wait a while yet. The Poles, Hungarians and Czechs are running budget deficits that will have to be cut by half or more to meet euro-zone rules. That will be politically hard, especially if the zone's biggest countries (eg, France and Germany) run excessive deficits without being penalised.

The best advice on political readiness heard at Krynica came from Alan Mayhew, a British academic.

Governments operating in Brussels should base their tactics on consistency and reliability, he said. Ministers and bureaucrats should speak with one voice, national positions should be clearly stated, and bargains struck with other countries should be kept. That may sound obvious, but it will be a big challenge for the shifting coalition governments common in central Europe. Another vital tactic, said Mr Mayhew, was to keep some flexibility in reserve—to have a Plan B ready for when Plan A gave way beneath you. Spain, he said, would already know what it was going to demand in exchange, if and when it had to yield on the constitution. Poland should be thinking fast, he implied, if it hadn't already done the same.

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Reform in Italy

Can it be done?

Sep 18th 2003 | ROME
From The Economist print edition

Italy's right-of-centre government fizzles with initiatives, but the prime minister's awkward dual role of politician and businessman makes it hard to enact them

Get article background

THE prime minister is his country's most successful company chairman and his ministers often sound like departmental heads, anxious to make sure the boss knows they are not sitting on their hands. Open any Italian newspaper or magazine these days and you are likely to find a Berlusconi minister talking about schemes for reform—the justice minister enthusing over leasing prisons, or the education minister explaining a plan for tax breaks for parents who send their children to private schools.

This week, the cabinet issued a blueprint for constitutional reform. To the opposition's consternation, it would enhance the prime minister's powers and trim the president's. But it also envisages a range of less controversial measures: a neater parliament of 612 members rather than the present 945, in which the two chambers would play different and apparently more complementary roles; more power to the regions, which would have more control over health, schools and local policing; and a special status for Rome.

Reuters

Pepping things up

The beginnings, then, of a real neo-liberal revolution in Italy? The next two-and-a-half years—the second half of Mr Berlusconi's term of government—will tell. Having fended off the possibility of a jail sentence, by getting parliament to pass a law granting him immunity from prosecution while in office, Mr Berlusconi can now concentrate his energy on reforming Italy.

But, however sincere his intention, he still labours under two handicaps. One is his coalition allies' different outlooks. The other is the enduring conflict of interest arising from his various roles, especially in the field of the media, which he dominates comprehensively. Of Italy's seven national television channels, his government can influence the three that fall within the embrace of RAI, the state broadcaster, while Mr Berlusconi's firm, Mediaset, owns the three main non-state channels.

So it is not surprising that the opposition, and quite a few MPs on his own side, balk at his government's main initiative in that area. A bill promoted by his communications minister, Maurizio Gasparri, would open the way to privatise RAI and bring in digital terrestrial television. Mr Gasparri insists his bill is a purely liberal reform to give viewers a wider choice.

If it were not for Mr Berlusconi's position as Italy's biggest media magnate by far, the opposition would probably have taken him at his word while merely harrying him over the details. Instead, it sees his bill as a plot to grab the airwaves for Mediaset and its allies. So the opposition is doing everything in its power to dish it.

Or take justice. Many Italians with no axe to grind have long felt that Italy's legal structure needs reform. Prosecutors and judges belong to one career structure, defence lawyers to another—a system that hardly bolsters a presumption of innocence. But as soon as Mr Berlusconi or one of his team moots the separation of judges and prosecutors, there is an outcry because of the suspicion that he is trying to nobble two professions that have repeatedly given him grief. So reform is blocked.

Or take pensions, widely regarded as the litmus test of Mr Berlusconi's will to change Italy. One of the keys to relieving the state of its current vast burden (state pensions gobble up 15% of GDP) is the phasing in of private schemes. Yet, there again, Mr Berlusconi cannot preach reform without appearing to sponsor his own interests: his vast business empire includes Mediolanum, a large insurance group that provides private pensions.

Conflicts of interest apart, Mr Berlusconi's supporters have profoundly contrasting outlooks. The biggest group, after his own Forza Italia (Go, Italy!) party, is the post-fascist National Alliance, which still harks back to a corporatist past, even though its leader, Gianfranco Fini, has edged steadily closer to a neo-liberal viewpoint. But many of his supporters are still wary of trimming the public sector. So is the coalition's small Union of Christian Democrats, a rump of the lot that used to run Italy.

In the case of pensions, the stoutest resistance has come from Umberto Bossi's once-separatist Northern League, the coalition's noisiest partner. Though it does not have the numbers in parliament to bring down the government, it holds the welfare ministry. Mr Berlusconi is said to be convinced that he needs the League's backing to survive. Many of its old supporters now vote for Forza Italia but, say pollsters, they might withdraw their support if Mr Bossi left the government.

Though ostensibly in favour of market reforms, the Northern League sings a very different tune when, for instance, they look like affecting what Mr Bossi calls “northern pensions”. Mr Berlusconi aims to raise the minimum retirement age. But northern workers tend to start regular employment earlier than in the rest of Italy, so have got used to retiring earlier.

The foot-draggers in the ruling coalition say that radical reform would play into the hands of Italy's trade-union leaders, who long to do Mr Berlusconi down. Union protests against Mr Berlusconi's pension-reform proposals put forward by his first government, in 1994, played a big part in its early downfall.

Small wonder that it took so long for the prime minister's allies to reach even an outline deal, earlier this month, on pension reform, or that the agreed changes were modest: no structural change before at least 2008 and, in the meantime, incentives to stay at work rather than penalties for retiring early.

Mr Berlusconi, the tycoon who turned politician, would like to go down in history as the man who modernised Italy at the start of the 21st century. But he lacks room for manoeuvre. That is partly because, in becoming a politician, he has never given up being a tycoon.

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Planning laws in Italy

Spy in the sky

Sep 18th 2003 | ROME
From The Economist print edition

Sending the left into orbit. Literally

ONE wheeze of Italy's prime minister is to raise *euro*1.5 billion ($1.6 billion) through an amnesty for Italians who have broken planning laws—provided that they pay a fine. Italy is smothered with illegal constructions—from lofts that break city skylines to entire tourist complexes, even in protected areas. Legambiente, an environmental group, says there are some 326,000 buildings that should never have gone up. The left is appalled by the government's plan, which it says will cost the taxpayer more than it earns because of the expense of laying on public services to newly legalised buildings.

Rome's left-led council is determined, with the help of high technology, to demolish as many illegal edifices as it can before the amnesty takes effect. Very high. Its public-works department has signed a contract with a firm called Telespazio to use a satellite, Quick Bird, to spot unlicensed building work from space. City officials say the prospect of an amnesty has set off an orgy of nocturnal construction. They hope that in future the threat of such activity being detected by a spy in the sky will be enough to deter it.

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Elections in Bavaria

One-party state

Sep 18th 2003 | MUNICH
From The Economist print edition

Why the conservatives will reign on

Get article background

EPA

A cabinet meeting, all in tune

IF FRANZ MAGET, the Social Democrats' candidate to be Bavaria's premier, avoids disaster in the state election on September 21st, he ought to thank terrorism. Earlier this week, it emerged that he had been a potential target of a neo-Nazi gang that had apparently planned to let off a bomb at the ground-breaking ceremony for a Jewish community centre in Munich. That, at least, helped voters know who he is.

Yet that welcome boost in name recognition won't help Mr Maget and his party much. While pollsters put his Social Democrats at around the 20% mark, the Christian Social Union (CSU), the independent Bavarian sister party of the conservative Christian Democrats, will probably get three times as many votes. The CSU, which has ruled Bavaria since 1957, may even win a two-thirds majority in the state parliament, giving it virtually absolute power. Why this extraordinary dominance?

To Edmund Stoiber, Bavaria's current premier who narrowly failed to become chancellor at last year's general election, the answer is simple: it's the successful economy—due, of course, to decades of brilliant CSU policy. Compared with the rest of Germany, Bavaria is indeed doing quite well: in the past decade, its GDP grew by more than 20% (against 13.3% in western Germany), unemployment is at 6.7% (versus 8.3%) and, at the end of last year, public debt reached only €1,572 a head, compared with an average of €3,974 for Germany's main western states.

Mr Maget counters that his opponents' success has more to do with the unique position of the CSU in Germany's political landscape. On the one hand, he says, the party has managed to be seen as the only organisation able to defend Bavaria's interests. On the other, it also has a national reach, giving its leaders a political stage that he and other top Social Democrats in Bavaria lack. If things look even worse this time, it is because the left-of-centre government in Berlin is now having to push through several unpopular reforms.

But there are other reasons. Bavaria used to be riven by regional and political differences. The economically liberal urban establishment was pitted against the conservative, church-minded rural folk. The CSU's achievement was to pitch a big tent for both camps, reconciling “progress and tradition”, to use the party's main motto (whose unofficial version is “laptops and *Lederhosen*”).

The CSU is not just a political party but a power network woven into Bavarian society. Choirs, sports clubs and other associations are stuffed with CSU members. Many of the board meetings of such organisations, goes a local joke, could easily double as city councils. Political and business elites are also highly intermingled, which explains why Bavaria has had its fair share of financial scandals.

Moreover, the CSU has managed to avoid the usual consequence of being in power for decades: ossification. It has been clever at rejuvenating itself without creating splits. As many as four centres of power (Bavaria's government, CSU members of the state parliament, the party organisation and CSU members of the federal parliament in Berlin) compete with each other but come together when it really

counts, says Andreas Kiessling of the Centre for Applied Policy Research at the University of Munich.

If there is a serious threat to the CSU's dominance, it is not the opposition but the weakening of the CSU's claim that it has been the main reason for Bavaria's economic success. The state is suffering from the high-tech sector's slump—and things could get worse, as chunks of the information-technology industry migrate to central European countries as well as to India and China. But an even bigger danger to the CSU could arise if the party loses its enthusiasm for healthy internal competition, which has been more or less stifled since Mr Stoiber took over the leadership.

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Greece's reforms

Just in time?

Sep 18th 2003 | ATHENS
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Can Greece's prime minister, Costas Simitis, hold on to power?

EPA

MOST Greek politicians still believe a burst of pre-election spending is the best way to win over wavering voters. In spite of his modernising European leanings, Costas Simitis, the prime minister, is no exception. What is new is his timing.

A general election is not due until April next year, but Mr Simitis's Pan-Hellenic Socialist Movement, better known as Pasok, is already campaigning as if it were imminent. First Mr Simitis announced a welfare package costing *euro*2.3 billion ($2.6 billion) to appeal to grumpy pensioners, farmers and women who have difficulty finding jobs. Then, on September 10th, he launched a “convergence charter”. Making a rare appearance live on television, he brandished a glossy handbook packed with details of Pasok's plans to raise Greek incomes from their present 70% of the European Union's average to 80% by 2008.

The charter has something for everyone: lower taxes for businesses and high earners, less spending on defence (now that Greece is on friendlier terms with its old enemy, Turkey) and more on education, pensions, training and job creation. Such plans would probably cost some *euro*7.7 billion to carry out. Cutting unemployment from 8.9% to 6% is a priority, says Mr Simitis. His government will even subsidise rents for families willing to move to places where there are more jobs.

The plan optimistically banks on the economy's continuing to grow by around 4% a year, even when next August's Olympic games are over and the current stream of hand-outs from Brussels slows to a trickle, as funds are diverted to poorer new EU members from central Europe. Moreover, inward investment remains small (Libya got more last year), largely because of red tape and officials wanting bribes.

Pollsters say about 20% of Greek voters are floaters who make up their minds only a few weeks before polling day. Still, Mr Simitis's early start may pay off. The first poll published after the unveiling of his convergence charter suggested it had gone down well. Pasok was trailing New Democracy, the right-of-centre opposition, by just under seven percentage points, against almost ten early this year.

Pasok has other ways to win people back. Michalis Chrysohoides, its new secretary-general, is trying to give the party a fresh look. Its die-hard Marxists and its nationalist faction are being shunted aside in favour of younger candidates with a softer, social-democratic image. Mr Simitis will appear more often on television, cutting ribbons around Athens as sports venues for the Olympics and more sections of a motorway are opened.

Will it work? After holding power for 19 of the past 22 years, Pasok may be due for a spell in opposition. Many of its old guard are unpopular, but Mr Simitis is still considered a safe pair of hands. Voters may be wary of switching just before the Olympics, which are seen as a test of Greece's credentials as a serious player in Europe.

Costas Karamanlis, the New Democracy leader, and his team are better than they used to be at picking holes in Pasok's grandiose schemes. But the latest announcements have thrown them into disarray. Six months ago they were expecting Pasok to fall, as one adviser put it, like a ripe fruit from the tree. Now Mr Simitis has offered a few plums of his own.

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Education in France

The bottom line

Sep 18th 2003 | PARIS
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Should parents smack their children? The great debate, in French

EVER wondered why French children are so unnaturally well-behaved in restaurants? Could the liberal use by French parents of a firm smack be responsible? According to one poll, 84% of them admit to smacking their children, a practice banned in countries from Sweden to Germany, and 51% say they do so often.

The French like to appear baffled, even amused, by others' efforts to ban the habit. A recent British move to outlaw smacking by child-minders made *Le Figaro*'s front page. Certainly, there is no taboo against smacking in public: many a harassed parent can be seen unapologetically slapping a tot in a park or supermarket. It is part of the repertoire of unsentimental child-rearing practices that set France apart from the indulgent child-centric American tradition. Surely, say the French, parents can be trusted to know the difference between the odd slap and repeated physical abuse?

This complacency, however, argue increasingly vocal child-protection groups, masks a serious problem. A culture that legitimises smacking can encourage the concealment of graver abuse. In 2001, 1.9m calls were made to an emergency childline service. Last week, Christian Jacob, the minister for the family, announced the setting up of an institute for child mistreatment. It will gather figures on the problem, assess early-warning policies, and consider whether to let child-protection agencies take civil action against parents suspected of violence. A television awareness campaign, which shows children hitting and shouting at a recalcitrant doll they are play-feeding, and carries the slogan “Being a parent is not child's play”, will also be screened.

Some campaigners want more. How is mistreatment to be defined? No Slapping No Smacking, an organisation set up in 1998, wants corporal punishment in the home outlawed. Its head, Dr Jacqueline Cornet, argues that smacking, however occasional, undermines children's confidence, weakens their emotional relationships, and encourages the use of violence to resolve disputes. Even French women's magazines and child-rearing books are beginning to counsel against the practice. “A child is not a puppy to be trained”, advises a recent issue of *Elle* magazine. Stand by for rowdier meal times in the brasserie.

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Charlemagne

The Stockholm syndrome

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Sweden's rejection of the euro spells danger for the European Union

SO WHERE does Sweden's refusal to join the euro leave the European Union? Three popular theories are doing the rounds. Call them “the inevitability of unity”, “the possibility of fracture” and the “the threat of catastrophe”.

Supporters of inevitability theory do not believe that the Swedish no raises any fundamental question about the drive for “ever closer union” in Europe. In a magnificently condescending phrase, *Die Welt*, a German newspaper, put the referendum result down to “a certain provincial eccentricity of Swedes”. A few Nordic weirdos, doubtless living in igloos inside the Arctic circle, will not halt the unstoppable momentum towards a united Europe. Indeed, a new European constitution, which EU governments next month will start negotiating about, should give the idea another big push. The “inevitabilists” point to history. In the past half-century, the EU has evolved from a modest coal-and-steel group of just six countries in 1952 to a union that, come next May, will number 25. There have been setbacks and crises before. But political and economic logic has driven the project forward, forcing many initially recalcitrant countries to join up. Don't worry about those Swedes and Brits, chortle the inevitabilists; even they will see sense in the end.

Others take Sweden's euro-rejection seriously and reckon that it might lead to the emergence of a “two-tier” or “multi-layered Europe”. Different countries within the Union will accept different degrees of integration. Most will adopt the single currency; the ten newcomers, due next year, must do so under the terms of their accession. But some countries may stay out for many years, perhaps forever. Meanwhile, the countries keenest on integration will forge ahead. For them, defence is the latest hot topic. Germany and France are determined to create an EU defence arm, with its own headquarters separate from NATO. The EU's more pro-American members, especially Britain and (soon) Poland, are against this idea. If disagreement persists, those keenest on a European defence union will go ahead on their own, with the inevitabilists predicting that recalcitrant countries will eventually see sense, and join up.

Believers in a multi-layered Europe are describing a pattern already visible: different EU countries already accept different degees of integration. And as the Union expands, its members are increasingly likely to have diverse needs and preferences.

But a two-tier Europe could throw up unexpected complications. Many of this model's enthusiasts reckon that the integrationists' natural “avant garde” is the EU's founding core of six: Belgium, France, Germany, Italy, Luxembourg and the Netherlands. It is certainly striking how all six are urging other EU countries to accept the draft European constitution now on the table without amendment. But the euro complicates efforts to form a hard-core Europe. Many promoters of ever closer union always believed that the single currency would both define and drive the EU's inner core. That was why some of them fought to keep countries like Greece and Italy out of the euro zone. But now there are 12 countries in it, and more to come. Is it really possible to have a closer defence and foreign-policy union which excludes some users of the single currency?

Even among the founding six, there are quite fundamental fractures. The Dutch and Italians are very wary of plans for a European defence union that might split NATO. And in the euro zone, the French and German governments have persistently violated the fiscal rules stipulating that no country can run a budget deficit bigger than 3% of GDP. The French prime minister's suggestion that his country's size and importance mean it should not be as constrained by such stability-pact rules as other euro-club members has particularly annoyed the Dutch, whose government is talking of taking France or the European Commission to court, to enforce the pact. The French are now changing their tone a little and insisting that they do take their responsibilities seriously. But the impression remains that France, while keen on

ever closer union in theory, has failed to appreciate its practical implications.

Murmurs and mutterings

“Catastrophe theorists” are eagerly watching to see what happens. What will France's famously bellicose trade unions do, if their country has to cut public services to meet the euro area's fiscal rules? And if France keeps breaking them, will smaller countries revolt? Already many of them echo the words of Frits Bolkestein, the Dutch European commissioner: “Some countries in the euro zone seem more equal than others.”

Unlike Sweden, neither France nor the Netherlands ever held a referendum on adopting the euro. Indeed, the only two countries to have held polls on euro membership—Denmark and Sweden—both rejected the idea. Goran Persson, the Swedish prime minister, had a point when he said after his referendum defeat that even the German people might have said no to the euro, had they been consulted. Now that the euro has been created, there is little sign of popular rejection in the 12 countries that are using it. But that could change as the practical constraints of euro-membership sink in. At the least, the current dispute makes an unpromising background from which to launch a renewed drive for deeper European integration by means of a new constitution for the European Union.

At this point in the argument, the inevitabilists—inevitably—tell catastrophists to calm down. The EU, they intone, has always survived crises. Indeed, a crisis has often created the pressure for the next big leap forward. True enough. But it is also the case that Sweden's referendum has provided a timely reminder of another deep truth about European integration. It is an elite project, with very shallow popular support. As the European construction adds ever more floors and features, its shallow foundations may make it increasingly rickety.

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The City

Tiner's tightrope

Sep 18th 2003
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The City has thrived because of light regulation. A heavier-handed approach may be on its way

IN HIS career, Sir Howard Davies has been, *inter alia*, deputy governor of the Bank of England, boss of the Confederation of British Industry, and a consultant at McKinsey, a management consultancy that is highly regarded by those who work for it. For the past six years he has been the chairman of Britain's main financial regulator, the Financial Services Authority (FSA), which in 1998 brought together Britain's ten regulators under one roof. He has done a tough job well.

On September 22nd Sir Howard will leave to become the director of the London School of Economics, and his job will be split in two. John Tiner, an FSA man, will be chief executive, and Callum McCarthy, late of Ofgem, the energy regulator, will be chairman. They will have to hold a delicate balance if London is to retain its status as the top international financial centre. That it should do so is of interest way beyond the square mile: financial services are Britain's single biggest export earner, with exports worth £13 billion ($19 billion) in 2001.

The City has been a success because Britain used to have an empire; because of its free-wheeling, risk-taking culture; because hiring and firing is easier than in the rest of Europe; and because of light taxes. But its regulatory environment has been crucial. The euromarkets, which trade securities outside their home jurisdictions, came to London in the 1970s and 1980s because American regulation was heavy-handed, and Britain's light.

Over the past two decades, power has moved away from the City. These days, fewer than a handful of big financial institutions are based there: the big investment banks' headquarters are in New York, Zurich, Tokyo and Frankfurt. Most of the City's business is done with customers elsewhere in the world. Yet, because of its favourable regulatory environment, the City dominates foreign exchange, international bonds and equities, and derivatives.

When the FSA was created, by folding in the banking-supervision department of the Bank of England with nine other regulators, there was an argument over whether it should adopt the Bank's supervisory approach, examining each case for malicious intent, or the more rules-based approach of America's regulators, such as the Securities and Exchange Commission, its chief market watchdog. The Bank's approach has generally prevailed, though the argument still rages.

The two regulators' approach to analysts' research illustrates the difference. In Britain, research must simply be demonstrably unbiased. The SEC, by contrast, details who banks can and can't talk to, who they can send research to, and insists on a long list of disclaimers at the end of a research note. Three pages of a four-page e-mail are often taken up with disclaimers.

The light regulatory touch has had its problems. The wholesale sector—companies selling services to companies—has been tarnished by the Wall Street scandals: research in London was as tainted as (almost) anything that Wall Street churned out. But the retail sector—companies selling services to individuals—has seen the worst troubles. First came the mis-selling of private pensions; then problems with endowment mortgages; the disaster of Equitable Life, which had sold pension policies it was unable to honour; and of split-capital trusts, which apparently divided up the trusts' capital into different risks, but which lost investors a packet. Supervisors, it is now clear, were asleep on their watch.

Retail regulation has now been beefed up. Punters have more and better information. Sales forces are better trained and more aware that regulators are watching them closely. And the FSA has been punishing miscreants.

There is a good argument for regulating those who sell products to ordinary people more closely than those who sell to the Prudential, say: such a big financial firm, it is generally assumed, knows what it is up to. Heaping costly regulation on big City institutions will simply drive their business elsewhere. The fear is of a one-size-fits-all regulatory policy that won't actually fit.

The danger is that the FSA reacts to all these pressures by becoming as prescriptive and rules-based as the SEC. That would drive up costs for the banks—their London legal teams would have to rise to the size of those in America—and thus discourage them from maintaining large London operations. It would also increase the cost of regulation. The FSA (which has 1,200 staff to cover all financial intermediaries, compared with the SEC's 3,100 to keep tabs on a much narrower range of instruments) would have to get far bigger.

Yet two recent FSA proposals, snappily titled CP171 and CP176, suggest that the regulator is moving in this direction. The first of these, mainly the result of the huge scandals on Wall Street, tries to get rid of conflicts of interest in banks' research departments by not allowing them to be involved with or remunerated by those who pitch for deals. The second aims to make fund-management firms, not the funds themselves, pay for research. Taken together, it is unclear who will be allowed to pay for equity research.

The regulations are aimed at banks' research departments, which have already been cut savagely. But independent research firms, which the regulator should want to encourage, say that CP176 would penalise them, too. And it is questionable whether thick Chinese walls are really needed in the fixed-income business, where the conflicts are not as great and the margins tiddly. Credit Suisse First Boston, for one, is considering shutting its fixed-income research department entirely.

The two new bosses come well recommended. Both are much lower key than Sir Howard, a man seemingly unburdened by self-doubt. Mr McCarthy built a reputation for toughness, and for letting markets take care of themselves. Mr Tiner has been at the FSA for only two years; before that he was at Arthur Andersen, which used to be a big accounting firm before it was destroyed by scandal. He also conducted the report on the 1995 collapse of the Barings bank for the Bank of England. Well versed, in other words, in scandal. Just the thing for a regulator.

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About sponsorship

The Murdochs

From Star to Sky?

Sep 18th 2003
From The Economist print edition

James Murdoch might not be as bad for Sky as investors think

PA

Has James got the vision?

RUPERT MURDOCH'S media empire, News Corporation, is an innovative and technologically savvy company. But it is also in the grip of one of the most ancient and irrational structures in the world: the family. Mr Murdoch intends to make his younger son James chief executive of BSkyB, Britain's leading pay-TV company, and investors are unhappy. The share price has dropped by 9% since mid-August when investors began to suspect that something was up.

Nepotism at News Corp is nothing new: the 30-year-old James runs Star, a wholly owned Asian pay-TV subsidiary, and his elder brother Lachlan is publisher of the *New York Post*, an unprofitable newspaper within the group, and its television stations. But this is the first time that the senior Murdoch, who together with his family owns 30% of News Corp's voting shares, has tried to insert a family member in at the top of a separate, publicly listed company.

News Corp owns only 35.4% of Sky, so investors may yet prevail upon its independent directors to block James's appointment. At the least, says Nick Bell, an analyst at Bear Stearns, if his son is to be chief executive, Mr Murdoch should consider leaving his current role as chairman.

Tony Ball, who runs Sky now and who will leave before his contract ends, increased the company's subscriber base from 3.5m in 1999 to 6.9m this June. Sky's great gamble—switching its customers from analogue to digital and giving out millions of digital set-top boxes—has succeeded brilliantly under his management. Until recently he was tipped for the top job at DirecTV, an American satellite television company being acquired by News Corp. But then he fell out with Mr Murdoch early this year, probably for having too many of his own ideas, a sin for which other News Corp high-flyers have suffered.

What will James do with Sky? The company's success is based on two things: customer service and football rights. But these days football rights are costly, growth in the subscriber base is levelling out and some people close to News Corp think the company needs to move on from its “dish-salesman mentality”. They reckon that with all the cash that Sky is pulling in each month, now could be the time to move into making more original content.

Home Box Office, a pay-TV company owned by America's AOL Time Warner, has made plenty of money out of hit shows such as “The Sopranos” and “Sex and the City”. But Britain may not be a big enough market for original programming, especially since Sky would be competing with the generous budgets of ITV, the main commercial broadcaster, and the BBC. Sky has tried making its own programmes before—with another Murdoch, Elisabeth—and soon gave up.

Investors would like Sky to use its cash to pay them dividends. They will be suspicious of any new venture promoted by James, who left Harvard early to run a music label and got News Corp to invest in Asian dotcoms. But he has proved himself over three years at Star, which has made its first full year of profit. If you were to draw up a shortlist of executives with solid experience of running pay-TV, says Mathew Horsman, director of Mediatique, a London-based consultancy, James Murdoch would be on it, regardless of his surname.

Perhaps the oddest aspect of this story is not Mr Murdoch's promotion of his children, but the way he plays them off against each other. Once Lachlan seemed to be the favourite; now James is. For a man to look after his sons is one thing; to set them against each other is another. Which lends support to the

conspiracy theorists who claim that Mr Murdoch is not anointing a successor, but diverting pressure from himself to step down from News Corp.

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Organised crime

Colourblind crooks

Sep 18th 2003
From The Economist print edition

Organised crime is a model of ethnic harmony

NEXT month, a microcosm of British criminal society will appear at Snaresbrook Crown Court, in East London. Prosecutors are pursuing the ill-gotten gains of Simon Pierre Fleur, Rumen Sinitchiyski and Darren Burgess, who have been sentenced to a total of 32 years in prison. The men's crime—heroin trafficking—is a traditional one, but, as their names suggest, they hardly fit the stereotype of nicotine-stained Cockneys working out a little earner in the Dog and Duck. Mr Sinitchiyski, who supplied the heroin, is a Bulgarian national living in London; the other two are from Manchester and Oldham.

By modern criminal standards, the group is hardly exotic. British society as a whole has become more ethnically integrated over the past three decades, while business has expanded its global reach. But nowhere have these changes been embraced more enthusiastically than among organised criminals. With the exception of a few intolerant regions, such as South Wales and Tyneside, foreign crooks have won acceptance from hard men everywhere.

This is especially true of drug traffickers. Heroin may be brought in to the country by West African drug mules or English lorry drivers working for Turkish or South Asian contractors; it is then distributed to middlemen and street dealers from Albania, Jamaica, Pakistan and Scotland. As Dave King, a National Crime Squad adviser, says, “these people will deal with anybody. They take very little account of ethnic differences.” As the networks become more complex, the prisons become more mixed: 12% of all convicts (and 36% of non-white ones) are now foreigners—up from 8% in the mid-1990s.

The increasingly rainbow-coloured character of organised crime is a clue to its maturity. As businesses, all criminal enterprises suffer from what economists call high transaction costs. Because they have no recourse to law, and cannot create binding contracts, they are liable to spend enormous amounts of time and money making sure that individual members (who are, after all, crooks) fulfil their obligations. This is why many start out as family or ethnic outfits. It is easier to obtain reliable recruits and then keep them in line if, as in the old New York Mafia, criminal hierarchies mirror social ones.

Some groups, like the smugglers who transport labourers from China's Fujian province into East Anglia at up to £20,000 ($32,200) a time, have not moved beyond this stage. But a gang that is reluctant to deal with outsiders will be unable to diversify its operations, or secure a broad market for its products. Most organised crime groups become more accepting of outsiders as they grow in size and ambition. The benefits that accrue from networking and increased openness more than compensate for the extra dangers.

On balance, the increasing complexity of organised crime has made things harder for the police. It is true that open-minded groups are easier to infiltrate. Edward Kleemans, a researcher at the Netherlands Ministry of Justice, says that Turkish rackets, which are notoriously good at checking the credentials of other Turks, are nonetheless vulnerable at the point of contact with other groups: “you can present yourself as an Englishman or a Belgian with some interesting contacts.” Yet this advantage is outweighed by the greater difficulty of breaking loosely connected networks. Crack down on one group of smugglers, and the bosses will hire another lot, perhaps from a different continent.

Police exasperation at these problems sometimes boils over into unwise public statements. In May, Chris Fox, a senior police officer, complained that “mass migration has brought with it a whole new type of crime, from the Nigerian fraudster to the eastern European who deals in drugs and prostitution.” He was rightly attacked—but for racism, which is the wrong reason. Gangsters rarely specialise in particular types of crime; they simply go where profits are to be made. To pretend otherwise only adds to their mystique. The Metropolitan Police have gradually learned not to talk too freely about Yardies or Triads.

As Tarique Ghaffur, the assistant commissioner, says: “from a marketing perspective, you can give these people too much kudos.”

Where does all this leave the old-fashioned British firm? Certainly not out in the cold. London police say that native crooks are heavily involved behind the scenes—facilitating trades, laundering money, and procuring firearms. At least, that is what the relatively small British-based criminals do. The big players have moved their offices to Spain and the Netherlands.

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Ethnicity

Black rainbow

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Black is not a colour: it is politics

PA

Ali Dizaei, black mark removed

THERE are several curious things about Ali Dizaei. He has been the subject of a staggeringly expensive, but fruitless, £3m-plus ($4.6m) inquiry into alleged corruption (all charges were dropped this week). He had an eyebrow-raising private life, featuring mistresses, exotic nightclubs and other distractions. He is also a leading figure in the National Black Police Association, despite being pale brown and born in Iran.

Officially, Britain has five main ethnic categories: white, mixed, black, Asian and other. Things can be broken down further, to 63 (ranging from oddities such as Cornish to huge catch-all categories such as “ex-USSR”). It is all voluntary: you can describe yourself as you like.

In the world of pressure groups, rules are a bit stricter. The black police association says skin colour is not the point: “The emphasis is on the common experience of racism” among police officers of “African, Afro-Caribbean and Asian origin”. A spokesman, David McFarlane, says that Asian in this context includes Middle Eastern (meaning Arabs or Iranians), but excludes Jews. They, he says, like Irish or Romany (Gypsy) police can join as associate members, along with “Aryans and Caucasians” [whites]. It is not particularly controversial, he says.

But views do differ. At one of Britain's main black information outfits, Blink, the editor, Don de Silva, is of Sri Lankan origin. “Black is a generic term and includes all ethnic minorities”, he says. That includes Jews.

The muddle reflects history: now outnumbered, blacks were once the biggest immigrant grouping. But campaigners say that highlighting the blurry edges of the black umbrella misses the point. Some groups campaigning against prejudice come under it, others march beside it. And other categories are just as tricky: if you think it is hard defining what “black” means, just try pinning down the meaning of “European”.

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Local government

A tale of two mayors

Sep 18th 2003 | HARTLEPOOL AND MIDDLESBROUGH
From The Economist print edition

Elect monkeys, get peanuts

Get article background

WHEN the government asked the people of Middlesbrough and Hartlepool to vote on whether they would like directly-elected mayors, locals were resoundingly in favour. It is not hard to see why the idea of change appealed to them. The prosperity of the 1990s seems to have passed both places by. The jumble of forlorn Victorian brick buildings, brutalist concrete shops, tatty office blocks and wasteland car parks in the two towns' centres suggest that both ran out of steam in the 1970s.

But even though most people voted for mayors, few thought they would make much difference. Their limited, ill-defined powers—they are supposed to set a strategic vision and provide leadership through a cabinet chosen from elected councillors, the remainder of whom scrutinise and provide a check on what the mayor does—encouraged a dim view of their prospects.

Ray Mallon, Middlesbrough's mayor, was the local police chief who began a hugely popular New York-style zero tolerance anti-crime campaign, starting with those littering the run-down chemical industry town. But then “Robocop” was suspended while an inquiry probed claims he was tolerating corrupt officers. It found no evidence to merit prosecution, but he then faced internal disciplinary charges. Proclaiming innocence, Mr Mallon pleaded guilty only, he says, to quit the police and stand for mayor. The townsfolk believed him. He romped into the town hall.

He showed who was top dog by cutting hostile councillors' perks. His old police bosses retired, so he made peace with the new chiefs. Then he reinvented zero tolerance, this time using council workers as community wardens and using police mapping techniques to send them to trouble spots. He boasts that “Middlesbrough is now cleaner and safer than York,” a paragon of northern bourgeois prosperity. He claims credit for the fall in burglaries from 400 to 220 a month in the past two years, and in car thefts from 900 to fewer than 500 a month.

Turning the economy round will take time, but at least the planners say they are now worrying more about how to get businesses into the town than about stopping them leaving. Mr Mallon has big plans for better services too, working on a scheme to build jointly with adjacent Stockton Council a bigger sports centre than either can afford individually.

People seem to like it. “We don't see so many prostitutes and the town centre is a lot cleaner since he became mayor,” say Emma Mitchell and Niall Best, third-year Teesside University students lunching al-fresco in the litter-free main shopping street. They say they'll stay locally if they can get jobs when they finish—reducing graduate departures is another of Mr Mallon's aims. His big asset is total self-confidence and charisma. “He's a great leader,” enthuses a formerly highly suspicious council official.

Stuart Drummond seemed to have plenty of that too when he, to his and everybody else's astonishment, was elected mayor of Hartlepool. The former call centre manager was better known as H'Angus, the monkey-suited mascot of the local football club.

Now smartly-suited, Mr Drummond has turned out to be no fool. But he seems bowed down by the task of running a council with a budget of £105m and 4,500 employees. Naively, he expected everyone to work happily with him for the town's benefit. But the 47 councillors are split between three parties and a clutch of independents, all apparently more interested in fighting each other. They also fight Mr Drummond—they defeated his efforts to curb council tax rises.

The threatened closure of a local hospital dominated a recent meeting and, he says dolefully: “They all seemed to be blaming me.” He is trying to enlist Peter Mandelson, the Hartlepool MP and original champion of the mayoral experiment, in a campaign to win jobs from the government's forthcoming civil service dispersal programme. “I have had no reply,” he says.

Mr Drummond shrewdly observes that, having decided the old council system was bad and that a new mayoral system was needed, Labour should not have been surprised that voters opted for new people. A real problem, however, is that the newcomers lack political skills; and in a system balancing power between mayor and councillors, inexperienced newcomers like Mr Drummond get chewed up by local politics. Mr Mallon's chutzpah has won him the upper hand. But if he messes up, he won't be short of enemies.

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House of Lords

For the chop

Sep 18th 2003
From The Economist print edition

As Christians to the lions, so hereditary peers to the Labour Party conference

Get article background

THE government hinted this week that it is about to bring forward plans to get rid of the remaining 92 hereditary peers in the House of Lords. At the same time, the new Lord Chancellor, Lord Falconer, promised to consult widely over more thoroughgoing reform of Britain's second chamber. What does this mean? That the reform of the House of Lords, once billed as evidence of the government's high-minded radicalism, has fallen victim to low cynicism.

Things looked bleak enough earlier this year, when MPs voted on various proposals for reforming the Lords. Votes were split among the different options, and none gained a majority. At the time, reform-minded backbenchers, many of them loyal Blairites, were shocked by the prime minister's apparent opposition, despite the Labour Party's repeated manifesto commitment, to any form of directly-elected second chamber.

After the inconclusive Commons votes, the issue was handed over to a committee of senior parliamentarians to chew over and come up with some recommendations that might gain wider support. This was plainly a delaying tactic. So why the flurry of activity now? Because with his fractious and divided party's annual conference due to start next weekend, Tony Blair needs anything he can get his hands on to appease his activists. There can be no going back on Iraq or the public services, so the poor old hereditaries are the obvious victims. As an added bonus, after promising to remove their well-bred behinds from the red leather benches, the government will find it easier to justify using the Parliament Act to push through its legislation to ban fox hunting—another sop to the party.

Ironically, as Lord Strathclyde, the shadow leader of the House of Lords, points out, nearly all the hereditaries want to see direct elections to their chamber: the very thing that Mr Blair is determined to prevent.

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The digital divide

Internet? No thanks

Sep 18th 2003
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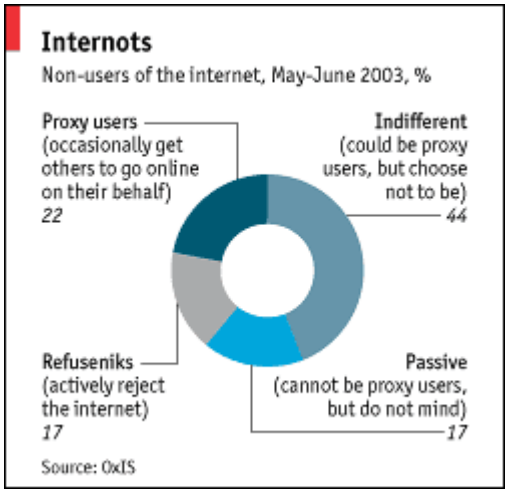
A new survey questions the notion of a digital divide



DESPITE the government's enthusiasm for the internet, and its many action plans, frameworks, guidelines and policies for getting Britain online, two in five Britons still do not use the internet. Why not? According to a new survey, it is not that non-users can't afford or don't understand it—they're just not interested.

Britain is behind America, but ahead of most of Europe, in getting online. Numbers are increasing, but only slowly. “Government and commerce will have to wait a generation or more before nine-tenths of Britons regularly use the internet,” declares Richard Rose of the Oxford Internet Institute (OII), a university-sponsored body, which earlier this summer carried out a survey of unwired Britain.

The survey found that 41% of Britons aged 14 and over do not use the internet. These non-users were more likely than users to be old and poor. But with internet access available in public libraries, cybercafés, job centres and even telephone boxes, age and income alone do not explain non-users' reluctance to go online. So the survey included special questions for non-users, to shed some more light on the subject.

It turns out that 22% of non-users are “proxy users” who have asked friends or relatives to do something online on their behalf (such as buy a book or send an e-mail) but see no reason to get connected themselves. A further 44% of non-users were classified as “informed and indifferent”. They know they could use the internet at a library, a café or a friend's house if they wanted to, but choose not to. A further 17% are “passive”—they do not know anyone who could do things online on their behalf, but do not mind. Only 17% of non-users are actively anti-technology. When asked if they felt disadvantaged by their non-use of the internet, some non-users said they thought it might count against them at work, but 96% said no.

That people are happy to remain non-users, even when access is available, illustrates that not using the internet is a lifestyle choice, not a form of social deprivation. Many people are used to doing things the old-fashioned paper-based way and see little reason to change, says Mr Rose, who oversaw the study. “People who don't use the internet haven't been convinced that it's useful...They just don't see the point of it.” Rather than a digital divide between users and non-users, he says, there is a “digital choice”.

This means that even if the government meets its self-imposed target of putting all government services online by 2005, many people will still not want to use them. The government attributes non-use of the internet to lack of access or lack of skills. But the real problem appears to be lack of interest. That said, all this internet apathy might have a silver lining. The government has also set itself the goal of making internet access available to everyone who wants it by 2005. That target appears to have been reached already.

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Strip clubs

Less is less

Sep 18th 2003
From The Economist print edition

Sex isn't selling so well

THE strip club business is not a classy one, unless your idea of class is broad enough to encompass heavy jewellery, pole-climbing women in high heels, and dubious claims of female empowerment. It has traditionally made up for this shortcoming by proving a rather good way of making money. But in this respect, the sheen has begun to come off the lamé.

In the past year, more strip clubs closed in London than opened—something that would have been inconceivable two or three years ago, when the American Spearmint Rhino chain led a rapidly-growing field. Some clubs went out of business as formerly *laissez-faire* councils, like Camden and Hackney, began to enforce stricter regulations. But others simply lost out, as more venues chased fewer punters. Even the perennially optimistic Peter Stringfellow describes the industry as “more serious” than it used to be.

The woes of the financial services industry are partly to blame. Bonuses and entertainment budgets are down, hitting clubs on the fringes of the city particularly hard. Tom Melody, proprietor of Ye Old Axe, in Shoreditch, reckons that besuited businessmen now make up no more than 20% of his customers, down from 40-50% a few years ago. “Go into any strip club in the 1990s, and you would see a row of gold and platinum cards behind the bar. You just don't see that any more.” A post-September 11th decline in American visitors hasn't helped matters.

Proprietors are not hanging up their medallions just yet, though. Some are moving north, where demand still outstrips supply. Many are converting their premises into “lap dancing venues” in a bid to extract more money from punters and performers alike. Strippers in lap dancing clubs (the term is a misnomer, given no-touching rules) make money not from stage shows, but from nude private dances, for which customers pay £10 or £20 a time. They pay to work, at rates that range from £35 a night in northern towns to £85 in Westminster, and hope they can take more than they pay out.

It's becoming increasingly difficult. Club owners are packing in more strippers—the supply appears undiminished, thanks to the opening of international borders and the breaking down of taboos—and competition among franchisees has reduced earnings. One woman, temporarily retired by pregnancy from her life as Kitty the Magical Stripper, complains that it is becoming harder to make ends meet: “Until recently, I never felt exploited in the industry. I would now.”

Competition, and the transferring of risk from proprietors to performers, also seems to have produced an increase in what one stripper delicately calls “rudeness”. Most clubs lay down strict codes of conduct—“when nude no open legs or floor work; no climbing on furniture” says one—but the pressure to add value is strong. That has led to greater surveillance and regulation by police and councils, which only makes matters worse. Those smiles are looking increasingly fake.

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Bagehot

The trouble with the BBC

Sep 18th 2003
From The Economist print edition

The Hutton Inquiry has exposed flaws in the way the BBC carries out its journalism

Get article background

THE Corporation must have been dreading this week. The BBC's main witnesses to the Hutton Inquiry into the death of David Kelly were recalled, and the director-general, Greg Dyke, was summoned. Three lawyers poked and prodded at the BBC's story, and found some distinctly vulnerable spots.

Things started badly with Mr Dyke's evidence. Mr Dyke is a confident character of whom a colleague once observed that “he puts the bull into ebullient”. But faced with the probing questioning of James Dingemans, counsel to the inquiry, about his conduct as the BBC's editor-in-chief throughout this crisis for the corporation's journalism, he appeared to shrink.

While nominally accepting the overall responsibility that comes with his exalted position, Mr Dyke seemed to have little conception of what was expected of him in terms of oversight. Weeks passed before he made himself even moderately acquainted with the circumstances surrounding Andrew Gilligan's story on the “Today” radio news programme claiming that the government had “sexed up” a dossier on Iraqi weapons. Although BBC news executives had doubts about Mr Gilligan's journalism, Mr Dyke apparently believed that all was well.

Mr Dyke's insistence that the BBC was not itself making any allegation about the government's honesty, but was merely reporting a source who might or might not be telling the truth, was unconvincing. (The “Today” programme's presenter introduced Mr Gilligan by saying, “[he] has found evidence that the government's dossier...produced last September was cobbled together at the last minute with some unconfirmed material that had not been approved by the security services.”) Mr Dyke also evidently failed to realise how big Mr Gilligan's story was. He told the inquiry that he had thought it had all gone away until Alastair Campbell, the government's head of communications, attacked the BBC in front of Parliament's Foreign Affairs Committee a month after the story was broadcast.

At that point, Mr Dyke might have tried to find out whether there were grounds for the government's complaint. Instead, he treated it as an assault by the government on the BBC's independence. He thus placed the governors in the false position of equating support for Mr Gilligan's reporting with loyalty to the institution and to the principle of independence.

Mr Dyke cannot be expected to know about everything that happens in the BBC's sprawling 3,400-strong news empire. Furthermore, he is a television executive rather than an experienced journalist. But complacency followed by naivety was precisely not what the BBC needed at such a moment.

When Mr Gilligan himself and Richard Sambrook, the BBC's head of news, were cross-examined, the corporation's main line of defence became clearer. Both admitted that mistakes were made in the way the story was presented, but stood by what they now say was its main thrust—that the dossier contained claims that some intelligence officials thought were exaggerated.

Mr Gilligan apologised, among other things, for revealing Dr Kelly's name, in an e-mail to the Foreign Affairs Committee, as the source of a separate story on “Newsnight” on television. Mr Gilligan and Mr Sambrook both admitted to errors of judgment and blamed the pressure they were under. Had they been willing to admit to mistakes when the row exploded, the government might have pursued the matter less aggressively, and Dr Kelly might still be alive.

Yet the BBC has still not backed down on the claim that the government “sexed up” the dossier, even

though a report last week by Parliament's Intelligence and Security Committee said categorically that it did not. The suspicion remains that Mr Gilligan may have made more of Dr Kelly's words than he should have: the line between interpretation and embellishment is thin. Other aspects of the BBC's account remain unsatisfactory. Mr Sambrook said the story was not put to Downing Street because questions about intelligence matters are never answered; but journalists who make serious allegations must put them to those they accuse. That no BBC executive admits to knowing of Mr Gilligan's e-mail to the Foreign Affairs Committee is less surprising. What is extraordinary is that Mr Gilligan was so unsupervised that he felt under no restraint.

The buck stops where?

Ten times the size of a well-staffed broadsheet newspaper, the BBC'snews team is too huge for hands-on editing from the top. But it does not help that the people who run it are usually sophisticated apparatchiks not great journalists. To carry off the kind of scoop-driven journalism that the “Today” programme has aspired to recently needs not just aggressive reporters and news editors, but the guiding hand of a powerful senior editor too.

Kevin Marsh, the editor of “Today”, was considered too lowly for Mr Dyke to have been made aware of his concerns about Mr Gilligan's reporting before the director-general went ahead with briefing the BBC's governors. Mr Marsh is at least a solid newsman, but his gifted predecessor, Rod Liddle, who hired Mr Gilligan, is a wild man. Under Mr Liddle, “Today” was rarely dull, but a culture of recklessness grew which is at odds with the BBC's obligations as the nation's broadcaster.

How should the BBC repair these defects? There are plenty of small things it could sensibly do, such as restricting the interviews between presenters and reporters—“two-ways” in the jargon—that often lead to stories being pumped up. It must also get a grip on staff correspondents who write opinion pieces in newspapers—an article by Mr Gilligan in the *Mail on Sunday* sprayed rocket fuel on the fire. But most of all, the BBC needs a powerful editor-in-chief, who, like the editor of a newspaper, would carry ultimate responsibility for news output and would therefore demand to be consulted over the handling of high-risk stories.

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Flying on one engine

Sep 18th 2003
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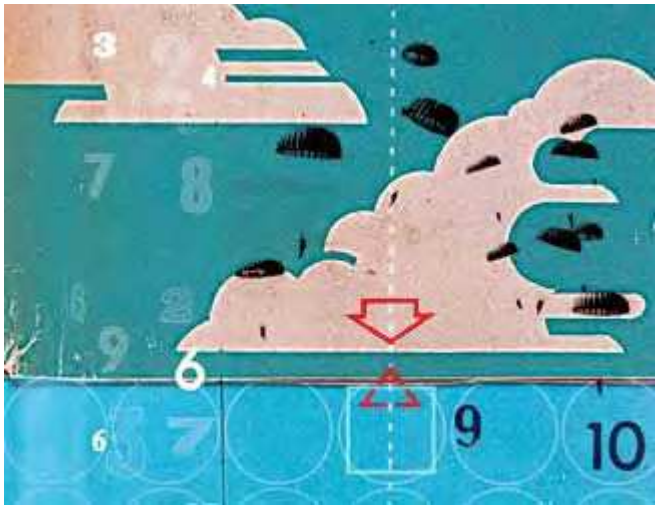
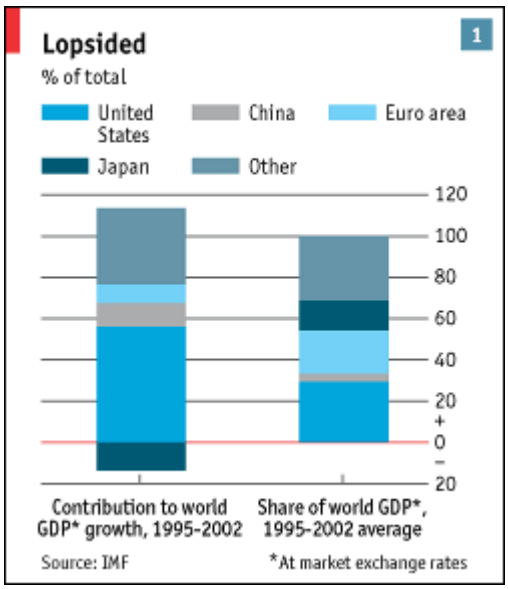


America can no longer propel the global economy. Unless other countries take over, argues Zanny Minton Beddoes, the economic outlook is grim and globalisation is at risk

THE evidence is still tentative, but America's economy seems to be gaining momentum. Consumers have stepped up their spending; the housing market is still sizzling; even manufacturing is perking up. For months, Wall Street's number-crunchers have predicted that America's real GDP growth will reach more than 4% in the second half of this year. That figure now looks more like a forecast and less like wishful thinking.

As the signs of an upturn accumulate, the relief abroad is palpable. From Mexico to Malaysia, the world is looking to America to lead a global economic rebound. In its latest projections, published on September 18th, the International Monetary Fund puts the growth in global GDP next year at 4.1%. But excessive reliance on America is also the biggest problem facing the global economy today. As Lawrence Summers, Treasury secretary under Bill Clinton, once put it: “The world economy is flying on one engine.”

The statistics are startling. Since 1995 almost 60% of the cumulative growth in world output has come from America, nearly twice America's share of world GDP (see chart 1). America's disproportionate contribution to global growth reflects an extraordinary rise in American spending. Domestic demand in America has risen, on average, by 3.7% a year since 1995, twice the pace of the rest of the rich world.



Just as flying on one engine is inherently risky, so a one-engined world economy is more likely to crash. Global prosperity depends overwhelmingly on American demand. If it were to drop significantly, the world would tumble into recession. Yet for years Americans have been spending far beyond their means.

America's national saving rate is at an all-time low. The country's current-account deficit—in effect, the amount it must borrow annually from foreigners to spend more than it produces—has been rising fast, and is now running at over 5% of GDP, a historic high (see chart 2). As a result, the United States, which as recently as 1980 was the world's biggest creditor country, has now become the world's biggest debtor country.

This survey will argue that the world cannot continue indefinitely to rely on American spending. The chances are that Americans themselves, weighed down by the burden of high debts, will eventually start to save more. But even if they do not, foreigners will become increasingly unwilling to fund American spending.

During the 1990s boom, it was American firms that powered the global economy with a huge debt-financed investment spree. But after the stockmarket crashed in 2000, investment spending collapsed as firms tried to strengthen their balance sheets. Total spending has kept going in part because American households have yet to make that adjustment. They, too, spent beyond their means during the 1990s bubble but carried on after the bubble burst, thanks to sharp cuts in interest rates that allowed them to borrow against their homes. American consumers' indebtedness is currently growing twice as fast as their incomes.

Increasingly, America's spending has also been fuelled by the government. The federal budget has shifted from a surplus of over 2% of GDP in 2000 to a deficit of over 4% of GDP this year. But ever bigger budget deficits will not be able to compensate forever if private spending flags.

Moreover, borrowing from abroad at an accelerating rate can go on only for so long. Eventually the interest on the debt will become too onerous. Long before then, however, foreigners will become reluctant to provide the necessary capital. Already the share of America's current-account deficit that is funded by private foreign investors has fallen. It is Asia's central banks – mainly Japan's and China's— that are picking up an ever bigger share of the tab by buying huge quantities of American government bonds.

Their motivation is not altruistic. By piling into American bonds, Asia's central banks keep their currencies weak, supporting Asia's exports to America. But America's growing trade deficits are now causing protectionist pressures at home, particularly against China.

In the past three years almost 3m jobs have been lost in American manufacturing, one out of six in that sector. With a presidential election due in 2004, demands for action against China are multiplying. Either Asia's currencies will have to adjust, or America will retreat from free trade. On both political and economic grounds, it seems, the world's reliance on one engine is reaching its limit.

Low on fuel

But how can the world be weaned off its over-reliance on American spending without sending the global economy into recession? In theory, the route to a more balanced world is clear. Americans must spend less and/or foreigners must spend more and/or the dollar must fall (because a cheaper dollar shifts Americans' spending away from imports and boosts exports). Ideally, most of the adjustment should come from higher spending by foreigners. If other countries revved up their economies, they would suck in more American imports. That would allow America's current-account deficit to fall without causing the world economy to suffer.

It has been done before. In the early 1980s, when Ronald Reagan was president, America also borrowed furiously from foreigners, pushing up the current-account deficit to over 3% of GDP. In the later part of the decade, that deficit came down again without causing a global recession, thanks to a big but controlled drop in the dollar and especially to booming economies in Germany and Japan.

Can history repeat itself? If today's current-account deficit could be painlessly reduced, just as it was in the 1980s, the one-engined world might not be such a problem. But the chances of a repeat performance are slim. The imbalances are much bigger and more entrenched, and the world economy as a whole is both more fragile and more complex. There are no other obvious engines, and there is no easy way to get the dollar down.

Given their economic size, the euro zone, especially Germany, and Japan remain the most likely back-up motors for the global economy. But these economies are in a mess. Both regions are having to cope with a worrying combination of ageing populations (which tend to dampen spending) and structural rigidities (which slow down growth). In recent years, both have also suffered from extraordinarily incompetent macroeconomic policies.

Japan, the world's second-largest economy, has had an abysmal decade of deflation and stagnation, brought on by its government's inability to deal with the aftermath of its own asset bubble in the 1980s.

In Europe, an obsession with tight macroeconomic policy has exacerbated the recent economic downturn.

There are some signs of change. In Germany, especially, there is now a recognition that the overtaxed and over-regulated economy has to be reformed. In Japan, the economy is perking up and there are glimmers of evidence that policymakers are at last grasping the need to reform. But both Europe and Japan have a long way to go before they can provide any back-up.

A less mighty dollar

With no alternative engines ready to kick in, the dollar will have to play an even more important role in America's adjustment than it did in the 1980s, when it fell by 55% against the D-mark and 56% against the yen. Since its peak in 2002, the dollar has already fallen by a total of 8% against its trading partners. But that is nowhere near enough.

Many economists reckon that, in the absence of a shift in global demand patterns, it would need to fall by 40% or more to make a serious dent in America's current-account deficit. That kind of depreciation is hugely risky. The more a currency falls, the greater the danger that it will fall too far, too fast. A sudden dollar crash could roil financial markets and plunge the world into recession.

Moreover, the dollar is unlikely to fall evenly against other currencies. The Asian central banks' determination to stop their currencies rising has, so far, concentrated the dollar's fall on the euro, with a 20% drop against the European currency since early 2002 compared with 8% overall. A further, even bigger drop in the dollar, targeted on the euro, would probably sink Europe's economies.

To spread the burden of a dollar drop more evenly, Asia's currencies too must appreciate. But that will not be easy either. In Japan—which has the world's biggest savings surplus and intervenes most actively to hold down its exchange rate—a dearer yen would lower import prices and further aggravate the economy's deflationary crisis.

Even in China, the case for a stronger yuan is not clear-cut. Unlike Japan, China is not running a big trade surplus. Its economy, despite rapid growth, is fragile; the banking system is bust. A sudden jump in the currency could cause the financial system to collapse, eliminating one of the few bright spots in the world economy.

With so many imbalances, and no easy adjustments in sight, the global economy is clearly in trouble. Stephen Roach, chief economist at Morgan Stanley (admittedly one of the most pessimistic seers on Wall Street), claims the world faces “its toughest array of macro problems since the end of the second world war”.

The risks of a dollar crash or a serious global recession are not insignificant, and a period of sluggish growth and currency volatility seems all too likely. The 1930s offer a lesson in how protectionism can flourish when economies are in recession and exchange rates tumble. For the past few years, politicians have done little more than hope that the American engine carries on working. But this is no longer good enough. Policymakers need to act to make a crash less likely and avert protectionist threats. A good first step would be to acknowledge the size of the problem.

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The price of profligacy

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How bad is America's borrowing binge?

“I JUST think it's a meaningless concept.” That was the verdict of Paul O'Neill, George Bush's plain-spoken first Treasury secretary, on the current-account deficit. Mr O'Neill reckoned it was silly to worry about external imbalances in a global economy where capital flows freely. Foreigners, he argued, put their money into America because it offered the best risk-adjusted returns. A current-account deficit was merely the accounting consequence of these capital inflows.

Mr O'Neill was pushed out last December and Mr Bush's current economic team may put things less bluntly, but many of them are equally relaxed about the current-account deficit. Some acknowledge that, over time, the deficit may need to shrink, but reckon that in large liquid global capital markets, any adjustment will be gradual and benign. None of them appears to lose sleep over the sustainability of America's external account.

Are they right to be so complacent? The current account is a tricky concept that reflects several different balances at the same time (see article). From one angle, it is just the accounting counterpoint to capital inflows. Viewed from a different perspective, however, it is the sum of the trade deficit (showing how much more Americans import than they export), plus interest payments to foreigners on previous borrowing. In other words, it reflects how much Americans are borrowing to finance today's spending and to service yesterday's debt. If they are borrowing too much, the deficit becomes unsustainable.

Just as an individual cannot pile on credit-card debt forever, so a country cannot increase the burden of its foreign debt indefinitely. Eventually, interest on the accumulated debt would use all the economy's resources, leaving nothing for domestic spending. In practice, however, the current-account deficit would have to adjust much earlier. Just when depends on a variety of indicators: the size of the accumulated debt; the rate at which new debt is piling up (the current-account deficit); the speed of economic growth; and the interest rate paid on the borrowed funds.

America's rate of borrowing is high and rising. At just over 5% of GDP, the current-account deficit is the highest in the country's history. Even in the final decades of the 19th century, after the Civil War, America's deficit was generally below 3% of GDP (though Canada and Argentina ran deficits as high as 10% of GDP in that period). In the Reagan era, the current-account deficit peaked at 3.4% of GDP.

Some of the recent rise may be a statistical quirk. According to official numbers, the world as a whole runs a current-account deficit with itself, and one that has risen sharply since 1997. Since the world does not, as yet, trade with Mars, the numbers must be wrong, so some of America's current-account deficit may be more apparent than real. But not all of the recent rise, or even most of it, can be explained this way.

In fact, America's current-account deficit is becoming worryingly large. Several studies suggest that economies hit trouble when their current-account deficits reach 4-5% of GDP. Caroline Freund, an economist now at the IMF and before that at the Federal Reserve, looked at 25 episodes of current-account adjustments in rich countries between 1980 and 1997 and found that the current account typically begins to reverse after the deficit has grown for about four years and reached 5% of GDP.

Another study at the IMF found only 12 episodes since 1973 where industrial countries have run a deficit of over 4% of GDP for more than three years in a row. All of the countries involved were relatively small and open economies.

Does it matter that America's current-account deficit is already an outlier by conventional benchmarks? Optimists claim not, pointing out that America has seen a big rise in productivity growth. That not only explains the higher borrowing (to fund the investment boom), but also makes it easier to finance the

debt. There is something in that. America's productivity growth did rise sharply in the late 1990s, pushing the economy's trend rate of growth from about 2.5% to 3-3.5%. But the current-account deficit has increased far more rapidly. Worse, it is still rising, even though the investment boom is over.

America is different

Second, argue the sanguine, America has unique characteristics that allow it to run a larger deficit. It can borrow in its own currency, which also happens to be the global reserve currency. And it has the world's largest and most liquid stock and bond markets. Certainly these advantages allow America to borrow more than others. They reduce the risk of balance-of-payments crises of the sort that befall emerging markets, such as Argentina or Mexico, where no one is willing to lend them money at almost any price. But they do not remove all limits.

A better reason to take comfort is that the stock of debt is still relatively modest. America resembles a rich man who has discovered credit-card bingeing late in life. At the end of the 1970s, after decades of almost continuous current-account surpluses, the United States was a creditor country, with a net stock of foreign assets worth about 10% of GDP. Persistent current-account deficits turned the country into a net debtor in 1985, since when it has been getting deeper and deeper into the red. At the end of 2002, net external debt reached 25% of GDP (see chart 4).

That is higher than the debt levels at which some Latin American countries hit financial disaster in the 1980s debt crisis, and on a par with the peak debt level America reached in the 19th century, but it is not especially high by the standards of other rich countries. Many industrial nations have net foreign debts worth 40-50% of GDP. Australia's debt stock, for example, reached 60% of GDP in the mid-1990s, and Ireland's peaked at over 70% in the early 1980s. The trouble is that on current trends, America's debt stock looks set to rise sharply. If the current-account deficit remains at 5% of GDP, and the economy grows by 5% in nominal terms (roughly its trend rate of real growth plus inflation of just under 2%), America's debt stock will reach 40% of GDP by 2007 and 60% in a decade (see chart 5).

The bottom line

Can America afford this kind of indebtedness? That depends on the interest rate it must pay. So far, it has got away lightly. Until 2001, more income was generated by America's investments abroad than was paid out from the United States to foreign investors, even though the country became a net debtor in the mid-1980s. Even in 2002, America's net payments on foreign investments were less than $4 billion, a relative trifle.

No one is sure why America pays so little for its borrowing. One factor is the difference in returns on foreign direct investment. Americans have tended to earn higher returns on their FDI than foreigners have earned on direct investment in America. This may be due to different tax treatment, or to the age of the investment. American investments in foreign factories are usually older and generate a bigger stream of dividends than foreigners' more recent purchases in America. The difference in returns earned by foreigners and Americans on portfolio investment, in contrast, is much less marked.

More important, the returns—both to Americans and foreigners—have been falling. Wynne Godley, an economist at Britain's Cambridge university, in a paper published by the Levy Economics Institute of Bard College, in New York state, has calculated a crude “quasi-interest rate” earned on America's external financial assets and liabilities, by dividing the payments received [and made] in one year by the stock of assets [and liabilities] at the end of the previous year. For the past two decades, both rates of return have closely tracked the yields on Treasury bills (ie, fallen sharply). Last year this quasi-interest rate fell

to just over 1%. Falling borrowing costs have, so far, masked the rising external debt.

That is unlikely to continue. In the years ahead, America faces a sharply rising debt stock and, quite probably, higher interest rates, so net interest payments to foreigners could become much more significant. If the average interest rate paid on external debt goes up to 3%, for instance, and the debt stock rises to 40% of GDP in 2007, as current trends suggest, Americans will be paying out close to $150 billion in interest, the equivalent of 1.2% of GDP. That would mark a huge increase from the current $4 billion, and could start to hurt.

Add all these factors together, and the trend in America's indebtedness will become unsustainable, but not for a while yet. More debt could be built up through a few more years of large and rising current-account deficits before the costs of borrowing start to have a dramatic effect on the economy.

But long before that happens, foreigners may become less willing to hold yet more American assets. Foreign investors' decisions are affected by two, sometimes conflicting, factors: the risk-adjusted returns that American assets offer, and the desire for a diversified portfolio. If American assets offer high returns, then investors may be prepared to buy more of them. But at some point the desire for a diversified portfolio will impose a limit.

Got enough greenbacks, thanks

Investors' recent behaviour suggests that foreigners' appetite for American assets may already be beginning to flag. In the past couple of years, the composition of capital inflows has changed significantly, and in a worrying direction. Private investors, who in the late 1990s were snapping up American shares, bonds and factories, more or less stopped buying anything but bonds in 2001. Foreign direct-investment flows, which reached a peak of 1.6% of GDP in 2000, have turned negative. And as purchases of American securities by private foreign investors have fallen, the current-account deficit has risen (see chart 6). According to Jim O'Neill, head of economic research at Goldman Sachs (and no relation to Paul), private portfolio flows and direct investment in the first three months of 2003 were worth only 1.4% of GDP. The remainder of the current-account deficit of 5.1% of GDP was funded by short-term speculative capital flows and official purchases of bonds by foreign central banks.

This lack of enthusiasm for American assets clearly shows up in the fall in the dollar since the beginning of 2002: to entice buyers, their relative price had to fall. Some of this drop may have been temporary, caused by low bond yields and a sluggish stockmarket. Indeed, as bond markets temporarily rallied in the second quarter of 2003, portfolio flows picked up. And as America's economic prospects have brightened in recent months, part of the dollar drop has been reversed. But there are also good reasons to believe that foreign investors have got enough dollar assets in their portfolios.

Every three months, *The Economist* asks a group of global portfolio investors about their asset allocation. The most recent figures show that American stocks make up 53% of the typical investor's equity portfolio and American-issued dollar bonds around 44% of the typical bond portfolio. Those proportions are slightly lower than at their peak in 2001, with 54% and 50% respectively. In the mid-1990s, in contrast, global investors allocated only around 30% of their assets to American dollar assets. In the late 1990s, therefore, the typical investor hugely increased the average share of American assets in his portfolio. In order to raise the average so quickly, the marginal investment in American assets must have shot up.

Catherine Mann, an economist at the Institute for International Economics in Washington, DC, who has pioneered the portfolio-based analysis of current-account sustainability, calculates that in 1998-2001 the typical investor allocated an average of 80% of his increased wealth to American assets. The question is whether this can continue. Ms Mann calculates that if the current-account deficit is to remain sustainable, foreigners will have to go on allocating 80-90% of their marginal investments to American assets over the next couple of years . That is not inconceivable, but it seems unlikely.

In sum, even if America could afford to take on more debt, foreign investors appear increasingly unwilling to hold it. True, foreign central banks, whose asset-allocation decisions are based on political as

well as economic criteria, could continue to pick up an ever-increasing share of the burden. But, as a later section of this survey will show, central banks cannot underwrite America's current-account deficit indefinitely. The chances are that an adjustment is close. It will not be easy.

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Facts behind the figures

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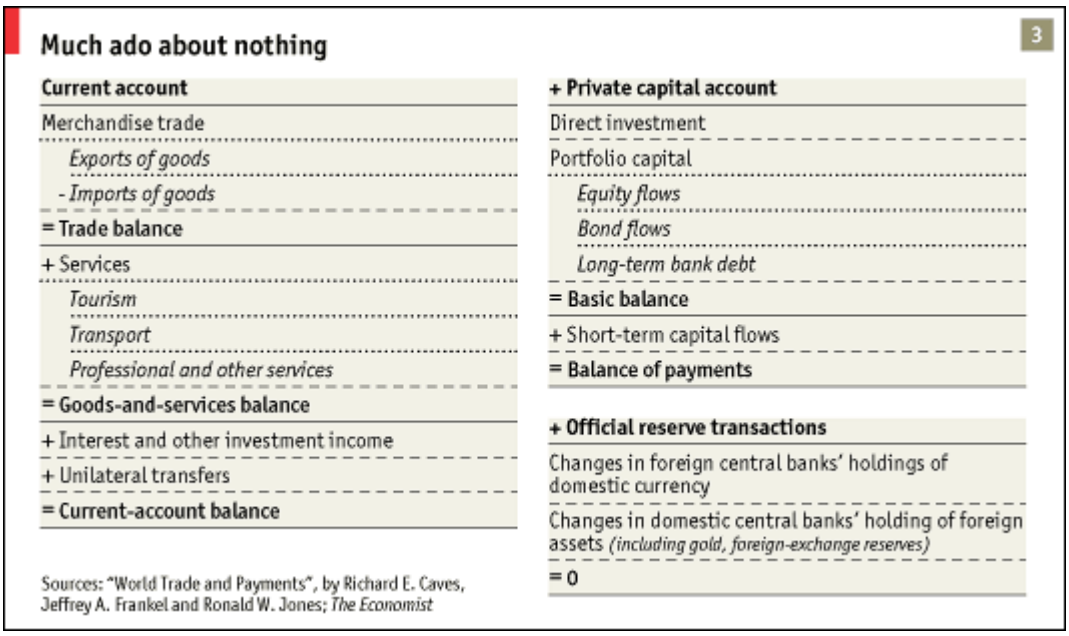

Much ado about nothing

3

Current account	+ Private capital account
Merchandise trade	Direct investment
Exports of goods	Portfolio capital
- *Imports of goods*	*Equity flows*
= Trade balance	*Bond flows*
+ Services	*Long-term bank debt*
Tourism	= Basic balance
Transport	+ Short-term capital flows
Professional and other services	= Balance of payments
= Goods-and-services balance	+ Official reserve transactions
+ Interest and other investment income	Changes in foreign central banks' holdings of domestic currency
+ Unilateral transfers	Changes in domestic central banks' holding of foreign assets *(including gold, foreign-exchange reserves)*
= Current-account balance	= 0

Sources: "World Trade and Payments", by Richard E. Caves, Jeffrey A. Frankel and Ronald W. Jones; *The Economist*

A quick guide to the balance of payments

JUST as a company's accounts can seem impenetrable to the layman, so a country's external accounts look intimidating at first sight. Like corporate accounts, they need decoding.

A country's balance of payments gives a snapshot of all transactions with foreigners. It has two main parts. The current account measures mainly trade in goods and services (known as the trade balance). It also includes interest paid on foreign borrowing (or received on foreign investments), as well as unilateral transfers abroad, such as official foreign aid and remittances by foreign workers.

The second part of the balance of payments is the capital account. It measures all asset transactions with foreigners. The private capital account is made up of private investments, whether foreign direct investment, stocks, bonds or bank loans. All official transactions (such as the central bank building up reserves) are dubbed “official reserve transactions”.

The sum of the current account, the private capital account and the official reserve transactions is always zero. Thus net capital inflows, whether private or official, imply a current-account deficit. Net capital outflows, in contrast, mean the current account will be in surplus.

But what do these balances mean in economic terms? A country that runs a current-account deficit is spending more than it produces, making up the difference by borrowing from abroad. Put another way, the current account is the difference between how much a country saves and how much it invests. A rising current-account deficit could imply rising investment or falling saving, or both.

To reduce a current-account deficit, a country must save more and/or invest less. Higher saving can come from the private sector (companies or households) or from the government through a smaller budget deficit.

The current-account balance shows the pace at which debt is being incurred (or, for a surplus country, the pace at which assets are being accumulated). The basic balance of payments (the current account plus long-term private capital inflows) gives a sense of how much a country is borrowing and how willing private investors are to fund that borrowing by providing long-term capital.

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Shrink-proof

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Why America's deficit is hard to turn around

IF FOREIGNERS lose enthusiasm for American assets, they simply click on a mouse. Capital markets are the most liquid and efficient markets in the world; billions of dollars can shift at the touch of a button. The problem is that the other side of America's balance-of-payments ledger—the world of imports and exports—is much more sluggish.

According to economics textbooks, shrinking an external deficit should be straightforward enough. For the current-account deficit to shrink, the trade deficit must fall, which means that America must import less and export more. That, in turn, means raising foreigners' appetite for American goods and services relative to Americans' own demand for them.

There are two main routes. Either overall spending by foreigners rises relative to American spending as other economies perk up, or (more painfully) America's economy slows down. To help things along, Americans should shift their spending towards goods produced at home. A cheaper dollar will encourage them to do that while boosting American exports at the same time.

The most effective engine of adjustment would be an autonomous increase in demand abroad for American goods, perhaps through faster growth in customer countries. In practice, though, it tends not to happen that way. The typical current-account adjustment, according to the IMF study cited earlier, is associated both with a sizeable fall in the exchange rate and with a drop in output in the adjusting economy. Ms Freund's study for the Federal Reserve reached the same conclusion, suggesting that a sustained export surge is the most important factor in turning round a deficit.

Although America finds it easier than most countries to fund its external deficit by sucking in foreign capital, its economy has a number of characteristics that make it much tougher than elsewhere to shrink that deficit. The first problem is the sheer size of it, and the huge gap between imports and exports (see chart 7). At just under $1.4 trillion in 2002, America's imports are worth almost 50% more than its exports ($974 billion). Closing the gap means exports have to grow much faster than imports. If imports were to increase by, say, 4% (about half their average growth rate since the mid-1990s, and consistent with modest economic growth in America), exports would have to rise by 11%, more than 1.5 times the average of the booming late 1990s, to reduce the trade deficit to $300 billion over two years.

Moreover, Americans have a particular penchant for imports. Back in 1969, two economists, Hendrik Houthakker and Stephen Magee, noticed an odd phenomenon: for any given rate of economic growth, America's imports tended to grow faster than those of other countries (and faster than America's exports). So if all countries were growing at the same speed, and exchange rates remained stable, America's trade deficit would worsen inexorably. To stop the deterioration, the American economy would have to grow more slowly than others, or the dollar would have to fall.

This phenomenon has long perplexed economists. Why should America be more addicted to imports than other countries? For a long time, economists thought it must have something to do with trade barriers abroad that prevented American exports from flourishing. But trade barriers, at least in the rich world, have been lowered substantially since the 1960s.

Another theory, pioneered by Paul Krugman in the late 1980s, is that Americans' apparent love of imports reflects the growing array of products made by countries that export to America. For any given rise in income, America's import demand is not abnormally high, he argued. Rather, it is the supply of exports

from fast-growing supplier regions, such as East Asia, that has been rising.

Another explanation points to the high levels of immigration into America. Immigrants, goes the argument, have a particular penchant for goods from their own country. Thus imports in a country with lots of immigrants will be relatively higher than elsewhere.

Lastly, there is the possibility that the relationship between growth and imports shifts as economies develop. Catherine Mann, from the Institute for International Economics, finds that the predilection for imports is much less pronounced in services than in goods. That suggests America's import bias will become less marked as the share of services in the global economy becomes ever larger.

For the moment, however, the import bias remains. In a detailed re-estimation of the statistics in 2000, three economists at the Federal Reserve, Peter Hooper (now at Deutsche Bank), Karen Johnson and Jaime Marquez, found that America's imports rose 1.8% for every 1% increase in overall spending. A 1% rise in foreign demand, in contrast, produced a less than proportional (0.8%) rise in American exports.

This lopsidedness, together with the sheer scale of America's current-account deficit, means that tackling it will be tricky. Unless other countries grow substantially faster, relative to America, than they do now, the bulk of any adjustment will depend on a depreciation of the dollar.

Down with the dollar

Back in the world of economics textbooks, a fall in the exchange rate improves the trade balance in two stages. First, the cheaper dollar increases the relative price of Japanese cars, French wines and Italian holidays. Cars from Detroit, chardonnay from California or trips to DisneyWorld, in contrast, become relatively less expensive. Second, this shift in relative prices encourages Americans to spend less on imports while boosting American exports.

In the real world, however, matters are more complicated. First, a drop in the exchange rate does not necessarily lead to an equivalent rise in the price of imported goods. This is partly because the final price of an imported good includes numerous costs, such as distribution and marketing, that are not affected by the exchange rate. Second, many countries that export to the United States (especially Asian ones) price their goods in dollars. Since these exporters are usually extremely keen to maintain their share in the world's biggest market, they often absorb the effect of a drop in the dollar by cutting their profits rather than raising the price.

Economists reckon that in the 1990s only about half of an exchange-rate change had worked its way through to manufacturing import prices after a year. Over a shorter period the effect can be even less. In the year to May, says Michael Rosenberg, chief currency strategist at Deutsche Bank, import prices to America, excluding oil, rose only 0.9%, even though the trade-weighted dollar fell by 6%.

But even if prices do move, spending patterns may remain much the same for a while, because consumers tend to be slow to adjust their spending in response to price changes. It also takes firms time to change orders and production levels. And even in the long run, the impact on imports of a drop in the dollar is weaker than that of a drop in income. According to calculations by Ms Johnson and Messrs Hooper and Marquez, a 1% drop in the dollar reduces Americans' demand for imports by only 0.3% in the long term. A 1% drop in income, on the other hand, reduces imports by 1.8%. So if a drop in the dollar is to make much of a dent in the trade deficit, it will have to be really big.

But just how big? The exact estimates differ, depending on how economists construct their models, but virtually all the numbers are startling. In perhaps the most optimistic analysis, Fred Bergsten of the Institute for International Economics reckons that the dollar needs to fall by another 15-20% on a trade-weighted basis to bring America's current-account deficit down to 3% of GDP. His calculation assumes some increase in relative demand from abroad. Failing that, the necessary currency adjustment becomes much bigger. Ken Rogoff, who is about to return to Harvard University after a two-year stint as chief economist at the IMF, and Maurice Obstfeld, an economist at the University of California at Berkeley,

reckon it will take a fall of closer to 35% to get the current account back into balance. Mr O'Neill from Goldman Sachs is even more pessimistic, estimating that a trade-weighted drop of 43% will be needed to reduce the current-account deficit by 2% of GDP by 2007. And Mr Rosenberg of Deutsche Bank thinks that if demand patterns stay as they are, a depreciation of 40-50% may be called for to get the current-account deficit down to 3.5% of GDP.

These are enormous shifts. If the burden were spread equally across America's trading partners, a 50% drop in the dollar would send the euro to well over $2 and the yen to less than 60 per dollar. With exchange-rate changes of this magnitude, the risk is that currencies may move too fast and perhaps even too far. Historically, exchange rates have tended to overshoot. In the 1980s the dollar soared, then plummeted. In Mexico in 1995, the peso plunged and then recovered. In the 1997-98 Asian crisis, Indonesia's rupiah dropped by over 75% before gradually creeping back.

Even big exchange-rate shifts can be absorbed if they occur slowly. (The 8% drop in the dollar since early 2002, for instance, has not caused any problems.) But if they happen quickly, financial markets are roiled, and at worst financial institutions are unable to cope with the strain. LTCM, a hedge fund, collapsed when interest rates suddenly shifted after Russia's default in the summer of 1998. If the dollar suddenly plunged, similar problems could arise.

The risk of a dollar crash and a subsequent financial meltdown are not negligible. Discussing the coming fall in the dollar, Mr Rogoff recently commented: “The world is set to jump off the top of a waterfall without knowing how deep the water is below.”

Nonsense, say the optimists; just look at history. In the early 1980s, America's current-account deficit rose sharply. Policymakers, economists and journalists fretted about the prospect of a dollar crash. A book published in 1985, “Deficits and the Dollar”, by Stephen Marris, epitomised the mood. “On present policies a hard landing has become inevitable for the dollar and the world economy,” Mr Marris argued. “The dollar will, over time, go down too far and there will be an unpleasant world recession.”

The dollar did indeed go down, just as he had predicted, but there was no nasty recession. Can history repeat that feat?

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Reaganomics redux

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Why the world cannot count on a repeat of the 1980s

PARALLELS abound between Ronald Reagan and George Bush. Like the Gipper, Dubya is a sun-belt conservative with a fondness for his ranch. In all, Mr Reagan spent about one year of his eight-year presidency at his California retreat. Mr Bush has turned his patch of Texan scrub near Crawford into the hottest destination for world leaders.

In economic policy, the script, so far, seems eerily similar. Both presidents introduced huge tax cuts and big increases in defence spending. Mr Bush has already cut taxes by as much as Mr Reagan ever did, though he has not, as yet, matched the 1980s defence build-up. Both men spilled huge quantities of federal red ink. During Mr Reagan's first three years the budget deficit rose by 3% of GDP. Mr Bush has doubled that figure, presiding over a deterioration of 6% of GDP in the federal finances since 2000. And under both presidents external imbalances spiralled. During Mr Reagan's first four-year term, America went from a balanced current account to a deficit of almost 3% of GDP. Mr Bush inherited a current-account deficit of 4% of GDP. It is now over 5% and rising fast.

Critics of the current president make much of these Reagan-Bush parallels. They point out that it took a decade of painful budget discipline in the 1990s to work off the budget deficits built up in the profligate Reagan era. How comforting, then, that the Reagan-era story has a happy ending, at least as far as America's external accounts are concerned. Having soared in the early 1980s, the dollar started to fall from 1985. A couple of years later the current-account deficit began to reverse. By 1991 it had disappeared. Though there were nasty scares, notably the 1987 stockmarket crash, there was no global financial meltdown and no global recession.

However, today's world is very different. A brief detour back to the 1980s will show why.

Morning in America

The Reagan era, like the current Bush presidency, began with an economy in recession. But unlike the mild downturn of 2001, the 1981 version was severe, with soaring unemployment and plummeting output. The recovery, however, was quicker and more dramatic. Helped by big tax cuts, America boomed. In 1982-84, American domestic demand grew almost 15%, against less than 3% in Europe and 5% in Japan.

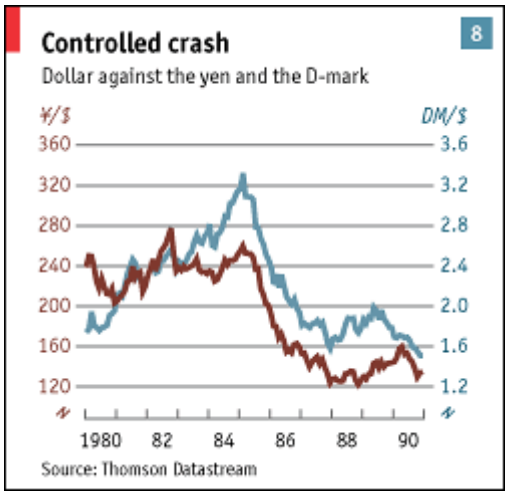
Unlike today, interest rates were high, so in 1980-84 the dollar rose by more than 80% against the currencies of its trading partners. The combination of a strong dollar and a strong economy sent America's trade deficit soaring. During Mr Reagan's first term, officials cared little about the strong dollar or the rising external imbalances. Like the current Bush team, they argued that a bigger external deficit simply reflected the attractiveness to outsiders of investing in America. The tone was defiant, even boastful. “In Europe they're calling it the American miracle,” Mr Reagan said in early 1985. “Day by day we are shattering accepted notions of what is possible.”

Within months, however, the mood in Washington had changed sharply. By the summer of 1985, the domestic political pressures from a strong dollar and rising trade deficit were becoming hard to contain. Congress was in a militant, protectionist mood. Japan was the scapegoat, blamed for hollowing out American manufacturing industry. Almost 100 trade bills were drawn up in 1985, each one of them protectionist.

James Baker, Mr Reagan's new Treasury secretary, realised that something had to be done to stem the protectionist tide. Over months of secret diplomacy, he put together a plan to secure international economic co-operation and currency intervention to push the dollar down. On September 22nd 1985,

finance ministers from the world's five biggest economies—America, Japan, West Germany, France and Britain—announced the Plaza Accord at the eponymous New York hotel.

Each country made specific promises on economic policy: America pledged to cut the federal deficit, Japan promised a looser monetary policy and a range of financial-sector reforms, and Germany proposed tax cuts. All countries agreed to intervene in currency markets as necessary to get the dollar down. Perhaps not surprisingly, not all the promises were kept (least of all America's on deficit-cutting), but even so the plan turned out to be spectacularly successful. By the end of 1987, the dollar had fallen by 54% against both the D-mark and the yen from its peak in February 1985 (see chart 8).



Keep it up

This sharp drop led to a new fear: of an uncontrolled dollar plunge. So in 1987 another big international plan, the Louvre Accord, was hatched to stabilise the dollar. Again specific policy pledges were made (America to tighten fiscal policy, Japan to loosen monetary policy). Again the participants promised currency intervention if major currencies moved outside an agreed, but unpublished, set of ranges.

Heavy foreign-exchange market intervention in 1987 did stabilise the dollar. Meanwhile, America's external deficit began to shrink sharply, helped by the big depreciation but even more by relatively faster growth abroad. In the late 1980s, domestic demand slowed in America but remained strong in Germany and boomed in bubble-era Japan. By 1990 America's current-account deficit was down to 1% of GDP. A year later, after America's modest 1991 recession, it was in surplus.

The story of the Reagan era helps explain why the current Bush team is keeping so calm about America's external imbalances. Serious as they seemed at the time, the excesses of the mid-1980s were purged with relative ease. But behind the superficial similarities, America's situation now is quite different from that in the mid-1980s. The imbalances are bigger; the international economic environment is more complex; and America's trading partners are weaker. All these factors suggest that the adjustment will be riskier and more painful.

Start with the size of the problem. When Mr Reagan took office, America was still the world's biggest creditor. The current-account deficit at its peak in 1987 reached 3.4% of GDP. Mr Bush, in contrast, inherited an economy that was already the world's biggest debtor, and a current-account deficit that was already bigger than at its peak under Mr Reagan.

Besides, in the 1980s the current-account deficit had been rising for only four years before the Reagan team took action. It also had a clear cause: an investment boom after the 1981 recession, coupled with a collapse in saving as the budget deficit ballooned, which together pushed the dollar sky-high.

Today's deficit, in contrast, has been rising for over a decade. It was started by an investment boom in the mid-1990s; then fuelled by a dramatic drop in private savings as Americans splurged in the late 1990s; and is now being sustained by a drop in public saving. An external imbalance that has gone on for so long, with so many disparate causes, is likely to be much harder to turn around.

Moreover, today's larger problem must be resolved in a global economic environment that is far more fragile than that of the mid-1980s. The world economy is still working through the aftermath of a huge asset-price and investment bubble. Inflation is much lower than it was in the mid-1980s. Deflation is already a reality in several countries, and hovers threateningly over many others. A drop in the dollar will put extra deflationary pressure on those countries whose currencies appreciate against it.

No appetite for action

Despite the world economy's greater fragility, global policymakers are showing much less appetite for 1980s-style international policy co-ordination. Not everyone views the Plaza and Louvre accords as a great success. Japan, in particular, blames the monetary easing agreed on at the time for the

development of its bubble economy in the late 1980s, and hence as the root cause of today's problems. Europeans tend to see both accords as clever American tricks in which the Reagan officials pushed the burden of dealing with their past profligacy on to others.

Even if the Japanese and the Europeans could be persuaded to overcome their suspicions of a repeat, it is not clear that the 1980s remedies would work this time. Co-ordination is much harder these days because of the way policy is made, particularly given the rise of independent central banks. Back in the 1980s, the governments of Germany and Japan could tell their central banks what to do. Now both the Bank of Japan and the European Central Bank jealously guard their independence. Both in Japan and in the euro zone, central bankers see themselves as guardians of discipline against spendthrift politicians. That makes domestic fiscal and monetary co-ordination difficult enough, never mind any international efforts.

Moreover, the huge growth in capital markets has rendered currency intervention much less effective. With over $1 trillion in foreign exchange crossing borders every day, up from less than $200 billion in 1985, most economists now think that official currency intervention works at best at the margin, and then only if it is used to reinforce existing economic trends.

Lastly, big changes in the structure of America's trade patterns mean that more countries would have to be involved in any adjustment process. In 1985, Japan accounted for 16% of America's trade; now that share is down to 9%. Meanwhile Mexico, China and some other Asian countries have become much more important partners. A round of financial diplomacy involving policymakers in only five countries would no longer do the trick.

But the main difference between today and the mid-1980s is that the adjustment paths used last time round—a big shift in demand away from America towards Japan and Germany, together with a substantial but orderly drop in the dollar—are blocked. As the next two sections will argue, both Japan and Germany face big hurdles and wrenching economic reforms before either can become an engine of global growth in demand; and Asian countries, which account for a third of America's trade, are refusing to let their currencies appreciate, ruling out an orderly depreciation of the dollar. That makes the prospects a lot grimmer than before.

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A pair of deadbeats

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From The Economist print edition

Can Germany and Japan be reinvigorated?

THEY are the world's second- and third-largest economies. Measured at market exchange rates, Japan and Germany together make up about 20% of global output. And they are both in a mess.

Germany's economy has been stagnant for three years. It is the sickest in a region with many weaklings. Unemployment is running at 10%. Japan's economy has barely grown for a decade, the worst performance of any rich country since the Great Depression. Both unemployment and public debt levels have doubled over the past ten years. Very recently, however, it has begun to show signs of life.

Japan and Germany (along with the rest of western Europe) also face serious demographic challenges as their populations age and fertility declines. Fertility rates in both countries are well below the level needed to keep the population constant. With a median age of 41, Japan has the oldest population in the world. Germany, Italy, Sweden and Switzerland are close behind. These demographics will make Japan and western Europe the first victims of the pension time-bomb that hangs over most of the rich world.

In America, by contrast, the population is younger and both fertility and immigration are higher. According to projections by the United Nations, on present trends the median age of Americans, now 35, will rise by only five years by 2050, and the population will grow by over 40%. Japan's median age, on the other hand, will rise by 12 years to 53, and its population will fall by 14%. Germany's is due to drop by 4% and Italy's by 22%. Falling and ageing populations will make it harder to boost demand. As people age and their children grow up, they tend to save more and spend less, though usually after retirement a prolonged period of dissaving sets in.

But difficult demographics are only one factor. More importantly, continental Europe's and Japan's economies have miserably failed to live up to their own potential, thanks largely to home-made policy failures. Better economic policy could give both regions a shot in the arm, and would certainly help the global economy to rely less heavily on America.

Top of the list in both Europe and Japan must be structural reforms to make labour and product markets more flexible and, in Japan especially, to overhaul the banking system. In addition, both need better macroeconomic policy to make reforms politically viable and allow them to work.

Does either region have the political will for reform? And can such reform be introduced ahead of the coming American current-account adjustment, which will make the task that much harder?

Frozen in time

In Europe, Germany is clearly the toughest nut to crack. It is plagued with rigidities and saddled with a huge, unaffordable welfare state. As a result, its trend GDP growth rate, at 1.5%, is the lowest in Europe. Until recently, Germany was also the least interested in reform. While the rest of Europe started, tentatively, to free up labour markets in the 1990s (creating more than 10m new jobs), Germany did virtually nothing. So when the global economy weakened in 2001, Germany was hit the hardest. But at long last even Germany is beginning to make a move.

Four months ago, if you were planning a dinner party on a Saturday night in Germany and had failed to buy the food before 4pm, your guests would go hungry. Every shop would be shut, by law. But new opening hours introduced in June give the would-be Saturday host until 8pm to stock up. After that, he should head for the nearest petrol station, which can stay open much later. Though officially allowed to sell only “travel provisions”, petrol stations have stretched the term to include such obvious motoring essentials as wine, ice-cream and washing powder.

Nor is ice-cream after hours the only innovation. In March Germany's chancellor, Gerhard Schröder, launched “Agenda 2010”, a package of reforms aiming to cut wage costs and make the economy more flexible. These include shortening the period during which unemployment benefit can be drawn, raising pension contributions and revamping health-care benefits. Mr Schröder also wants to bring forward a long-planned reduction in the top rate of income tax. The idea is to have all these reforms in place by the beginning of next year. Though this is far from certain to happen, there are encouraging signs. Mr Schröder has secured agreement from the opposition on sizeable chunks of the agenda, including health-care reforms and bringing forward the planned tax cuts.

If successfully implemented, Agenda 2010 would have big long-term benefits. It would make German labour markets substantially more flexible and reduce the burden on employers of high pension and health-care costs. In a recent study the IMF concluded that reducing the rigidities in Europe's employment and product markets to America's levels would boost the region's output by 10%. Agenda 2010 may not turn Germany into America, but according to Adam Posen, an expert on Germany at the Institute for International Economics in Washington, DC, it is the most ambitious package of reforms Germany has seen in 40 years.

Nor is Germany the only European country trying to make its economy more flexible. The French government passed a big pension-reform package in July, defying widespread strikes. Although the package excludes mollycoddled and strike-prone groups such as railway and utility workers, it goes much further than anything attempted before. Next on the agenda is the rationalisation of French health care, to be tackled later this year.

Fine efforts, but will these reforms (assuming they materialise) actually boost demand? After all, without higher domestic demand Europe will not be able to play its part in rebalancing the global economy.

In the long term the answer must be yes. Structural reform will allow Europe's economies to grow faster, thus allowing a sustainable rise in overall spending. But in the short term, the answer is less clear-cut. Reduced wage costs and greater flexibility should cause firms to invest more, but cutting long-cherished benefits and weakening safety nets may also prompt workers to save more, particularly if the overall economic environment is tough. That is why it is so important for Europe to get its macroeconomic policy right.

Tight-fisted

This presents a problem. For despite continental Europe's economic weakness, macroeconomic policy there has been far tighter than in America or indeed in Britain. This year, fiscal policy in America has been loosened by almost 2% of GDP, whereas in the euro area as a whole, and especially in Germany, it is being tightened (see chart 9).

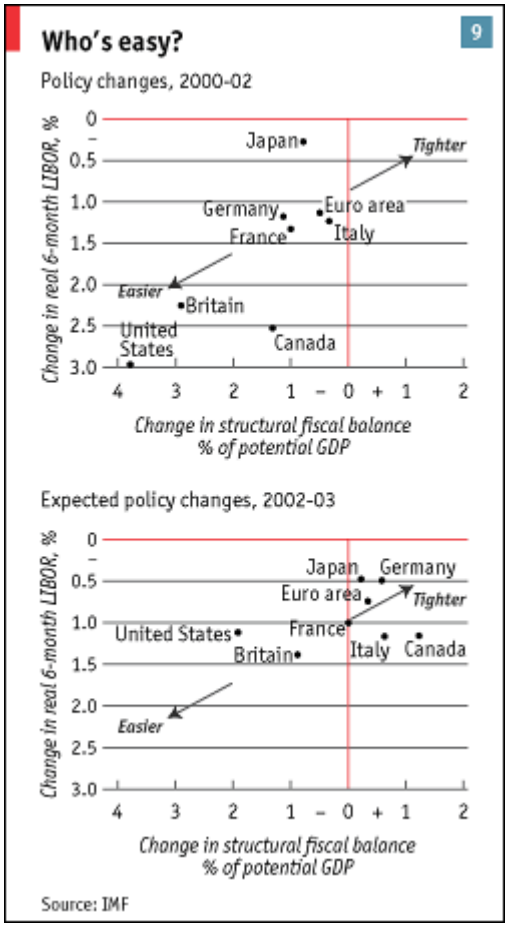
The tight fiscal policy in Europe has resulted mainly from Europe's self-imposed policy strictures, particularly the Stability and Growth Pact. This requires countries in the euro zone to limit deficits to a maximum of 3% of GDP, other than in extraordinary economic circumstances. Countries that run excess deficits and fail to reduce them can be fined by the European Union. But the efforts to comply with the pact have led to perverse results. Earlier this year, for instance, Germany was talking about raising taxes in the middle of a recession to get its budget deficit down.

However, the roots of Europe's macroeconomic stance go well beyond the stability pact. Whereas America has rediscovered Keynes with a vengeance, European officials remain deeply sceptical about the ability of macroeconomic loosening, and particularly fiscal loosening, to smooth economic cycles. European economists, including several based at American universities, have spearheaded research that shows how, in theory, fiscal tightening (especially spending cuts) can actually boost the economy. A recent study by the European Commission claimed that roughly half the instances of fiscal tightening in the EU during the past decade had been followed by faster economic growth. Conversely, they argue, the evidence that fiscal expansion works is much

thinner.

They have a point. Given that Europe's overall fiscal position is worse than America's—with higher tax rates and bigger debt burdens—there is less room for loosening and greater benefits to be reaped from discipline. But that does not mean that fiscal policy has no role to play.

Indeed, Europe's big economies now seem to be coming round to the view that it has. France, Germany and Italy, as well as Portugal, are currently flouting the 3% ceiling on deficits. Yet Germany is hoping to bring forward much-needed tax cuts that are likely to make the deficit worse. France, too, looks set to breach the stability pact again next year and Jacques Chirac, France's president, advocated a "temporary softening" of it this summer. The point is not that Europe can, or should, spend its way out of the current downturn, but that fiscal policy should avoid aggravating cyclical downturns. With luck, that trend has now started.



Monetary policy in the euro zone has also been tighter than in America. Since the beginning of 2001 the European Central Bank (ECB) has cumulatively cut short-term interest rates by 2.75 percentage points, whereas the Federal Reserve has cut short-term rates by 5.5 percentage points. Here, too, the differences are partly due to intellectual attitudes and partly to self-imposed rules.

Whereas Alan Greenspan, the chairman of the Federal Reserve, has adopted the role of recession-avoider-in-chief (in line with the Fed's goals of maximising employment as well as stabilising prices), Europe's central bankers have been dogmatic inflation fighters (their only official goal being inflation close to, but below, 2%). They are also self-styled drill-sergeants for structural reform.

Despite widespread criticism from the IMF, the OECD and the financial markets for cutting rates too slowly, the ECB remains unabashed. Wim Duisenberg, the bank's boss from its inception, once famously quipped that a bout of falling prices was a central banker's dream. He has regularly claimed that Europe's problems are structural, not monetary. Jean-Claude Trichet, a former governor of the Bank of France, who is expected to take over from Mr Duisenberg in November, may take a softer line.

But it is not just a question of personality. A large part of the difficulty lies in making policy in a currency union of 15 disparate economies. The ECB's decisions on interest-rate changes are based on region-wide inflation averages, which across the euro zone as a whole have consistently bumped up against the ECB's target of 2%. However, inflation in Germany—which makes up 30% of the euro zone's economy—has been rather lower than the average. So interest rates that are appropriate for the euro zone as a whole are too high for Germany.

To aggravate matters, Germany has a much weaker banking system than the rest. Like Japan, it has too many unprofitable banks that need rationalising and restructuring. While this is being done, banks are reluctant to lend, so credit growth is stagnant. The pessimists about Europe say that the state of Germany's banks, its structural rigidities and its low inflation raise the spectre of Japan-style deflation that could sink the economic prospects of the entire euro zone.

Do trains pull locomotives?

Optimists about Europe—of whom there are a few—suggest that whereas the ECB may not have loosened interest rates enough for Germany, its cuts should be enough to get demand going again in the rest of the euro zone. Growth there, they argue, will eventually pull Germany along too. Analysts at Goldman Sachs, for instance, point out that real interest rates outside Germany are negative, and that the euro zone as a whole has a relatively healthy balance sheet and little spare capacity. They reckon the ECB's rate cuts so far will be enough to boost the growth in domestic demand in France from 1.1% this year to 3.1% next year and in Italy from 1.4% to 2.9%.

Given Germany's weight in continental Europe, the idea of robust European growth without Germany seems a stretch. But whether the macroeconomic optimists or pessimists win the day depends in large part on what happens to the euro.

The lobby of the ECB's Frankfurt headquarters is decorated by a large round mural of the euro currency, half bathed in sunshine and half submerged under water. This strange installation symbolises the risks facing Europe, and hence the world economy. If the euro emerges too quickly into the sunshine, it could sink Europe's economies, because the overall economic effect of a stronger euro is similar to a tightening of monetary policy. Indeed, the ECB's rate cuts this year have barely offset the rise in the euro. A further drop in the dollar and appreciation in the euro, particularly a sharp one, would soon far outweigh any monetary loosening from the ECB. Tighter macroeconomic conditions would not only deter growth in demand, but would also make much-needed structural reforms politically more difficult.

In short, a fast-rising euro, which could take some of the pressure off America's current-account deficit, could harm Europe's economies, and hence any hope that a second engine for the global economy might get started.

If Europe's macroeconomic policies have made a difficult situation worse, then Japan's have turned a structural problem into a slow-motion disaster. Although the details are different, the broad script—necessary structural change put off and then made harder by macroeconomic ineptness—is exactly the same.

Will the sun ever rise?

Japan's main problem is its inability to restructure the financial system that collapsed after the 1980s bubble economy burst. Too many bust banks remain open, keeping too many unproductive firms alive and locking resources into weak areas of the economy. The prescription is simple: Japan's banking system needs an overhaul to create a more effective system of credit intermediation which, in turn, would force much-needed corporate restructuring. Yet for a decade the government has failed to come to grips with the problem. This has caused the economy to stagnate and get caught in a deflationary cycle. With prices falling, the real value of the debt held by Japan's bankrupt banks and firms has risen, deepening the financial quagmire.

Conventional wisdom argues that Japan tried, and used up, all the traditional fiscal and monetary tools. Though government debt doubled and short-term interest rates fell to zero, the economy stayed in a rut. Keynes seems to have failed.

The reality is more subtle. As the IIE's Mr Posen, and Kenneth Kuttner, of the Federal Reserve Bank of New York, have persuasively argued, Japan's fiscal policy has on balance been tight. Despite intermittent huge public-spending programmes, they point out, over 80% of the increase in Japan's public debt has been due to lower tax revenues from a shrinking economy.

On the monetary side, the Bank of Japan did too little, too late. It was slow to cut interest rates after the bubble burst in 1990 and refused to reflate the economy by printing yen to buy government bonds or other assets. Though there have been tentative efforts in that direction during the past year, they did not pack enough of a punch once deflationary expectations had set in. Instead, Japan's most proactive macroeconomic policy has been massive intervention in the currency markets to stop the yen appreciating against the dollar and cutting off the relatively small but vibrant export sector. So far this year the Japanese government has spent around $80 billion buying dollar assets. In other words, Japan's only policy has been to stave off the dollar devaluation that would help to rebalance the world economy.

Can Japan sort out this mess? At first sight, the task looks more manageable than Germany's. Japan's problems are concentrated in the financial sector, whereas Germany's span the entire economy. But unlike Germany, Japan is showing no sense of urgency, nor does it have a clear reform agenda. There have been some signs of progress, particularly the government's recent bail-out and restructuring of Resona bank. But there is still little evidence that policymakers are willing to undertake large-scale financial reform.

A number of outside observers have concluded that Japan must be forced to undertake structural reform by letting its currency appreciate substantially. They argue that during the second half of the 1990s the weakening of the yen allowed Japan to put off structural reform, and that now the government is deliberately putting it off further through its currency intervention. A much stronger yen would bring

about the much-needed structural reform, at the same time as helping to reduce the American current-account deficit.

A little arm-twisting

Fred Bergsten, head of the IIE, is one of the most vocal proponents of this thesis. In a recent testimony to Congress he said America should tell the Japanese to stop intervening to keep down the yen. If necessary, the administration should threaten to sell dollars to offset the Japanese efforts. However, many economists disagree with Mr Bergsten, arguing that the tighter macroeconomic environment created by a sharply raised exchange rate would aggravate deflation and make the banking reform unnecessarily painful. Even John Snow, America's Treasury secretary and the man ultimately responsible for any currency intervention, acknowledged that Japan's desire to stop its currency appreciating is understandable. “They need a strong export sector to get their reforms done,” he said this summer.

More important, the process of reflation—crucial to getting Japan out of its mess—is likely to mean a weaker rather than a stronger currency, at least in the short term. There is a growing consensus among Japan-watchers, led most recently by Ben Bernanke, a governor of America's Federal Reserve and a renowned monetary economist, that an ambitious combination of fiscal and monetary easing, coupled with a clear inflation target, would jolt Japan out of its deflationary spiral. In a recent speech in Tokyo, Mr Bernanke argued in favour of big tax cuts financed by the purchase of government bonds by the Bank of Japan.

This might prove the surest route to boosting Japanese demand, but it is unlikely to strengthen the yen, at least in the short term. And even as it got the Japanese economy going again, thus helping to reduce the world's over-dependence on America, it would aggravate another problem which adds to that dependence: the extreme reluctance of most of America's Asian trading partners to let their currencies appreciate.

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Oriental mercantilists

Sep 18th 2003
From The Economist print edition

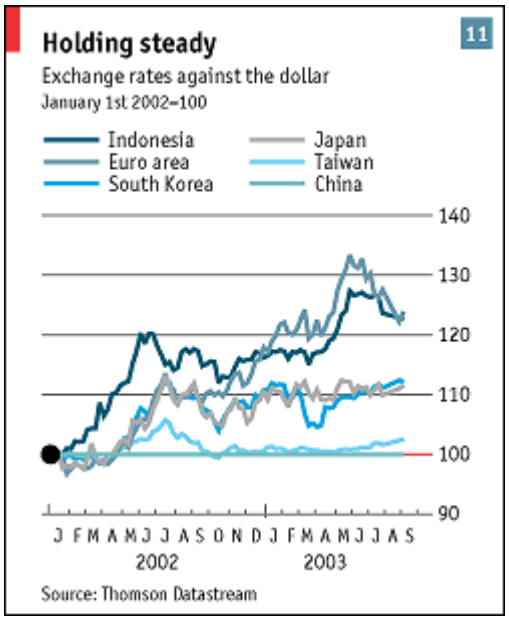
Asia's addiction to cheap currencies must end. But not overnight

THE average homeowner in Peoria has probably never heard of Toshihiko Fukui, Zhou Xiachuan, Joseph Yam, Perng Fai-nan or Park Seung. But he has a lot to thank them for. These men, respectively bosses of the central banks of Japan, China, Hong Kong, Taiwan and South Korea, have become the world's most enthusiastic purchasers of American government debt, including that of the mortgage giants, Freddie Mac and Fannie Mae. Their appetite for Freddie's and Fannie's bonds keeps the dollar relatively strong, and mortgage rates in Peoria down.

Between them, these five Asian central banks hold around $1.3 trillion in official reserves (or over half of the global total), most of them in dollar assets. Since December 2001, Japan's reserves have shot up by 36%, China's by 65% and Taiwan's by 49% (see chart 10).

The Asians' passion for American bonds is explained by their desire to stop their currencies appreciating against the dollar. China and Hong Kong fix their currencies against the dollar, in Hong Kong's case through a currency board. That means a current-account surplus or big capital inflows automatically translate into higher reserves. The other countries ostensibly let their currencies float, but heavy intervention by central banks has ensured that Japan's yen and South Korea's won have risen by over 13% against the dollar since the beginning of 2002, compared with a 25% increase for the euro, another floating currency (see chart 11).

For the man from Peoria (and for America's economy), this has brought a short-term benefit. The dollar's fall over the past 18 months has been smaller and more gradual than it would have been without the Asians' intervention. The trouble is that the Asian dollar binge is putting off the inevitable adjustment to America's current-account deficit. America continues to accumulate foreign debt at an ever faster rate, so the eventual adjustment will be correspondingly bigger. At the same time a disproportionate share of whatever decline in the dollar does materialise falls on those countries that let their currencies float, especially the euro.



Crying foul

Small wonder, therefore, that complaints about the Asians' behaviour are getting louder. When Europe's finance ministers met their Asian counterparts at a summit in Bali in July, they made a fuss about those weak currencies. America's Treasury secretary, John Snow, went to China earlier this month specifically to lobby for a change in the exchange-rate regime. And tensions are rising within Asia itself. The Japanese are unhappy about the undervaluation of China's currency, and the South Korean government recently suggested that China should allow the yuan to appreciate.

Broadly speaking, those complaints are justified. Asia's currencies must play a part if the world is to stop relying on the single American engine. But too many of Asia's critics oversimplify both the dilemma facing the world economy and the difficulties facing individual Asian countries.

In the short term, Asia's central banks are right to claim that they are supporting the world economy, not undermining it. Were Mr Fukui and his friends to give up on American bonds overnight, the dollar would plummet and bond prices would soar. To help the world economy, the adjustment needs to be gradual—a point that is often lost on the shrillest foreign critics.

Second, Europeans, especially, tend to exaggerate how much they are suffering. True, the euro has borne a disproportionate share of the dollar's adjustment so far, but without the Asians' interventions the fall in the dollar would have been steeper, so in the short term the Europeans may not be much worse off. The point is not that the Asians are harming the Europeans in particular, but that they are preventing the adjustment of America's imbalances, making the long-term problem worse.

Third, although Asia's central banks are all doing the same thing (buying dollars), their economies are by no means all in the same boat. This suggests that no single solution will suit everyone.

Too much of a good thing

Rising foreign-exchange reserves are not necessarily a bad thing. Countries need reserves to guard against sudden shocks; say, a big drop in exports or an unexpected drying-up of foreign lending. As economies grow, so the level of reserves tends to rise. In general, more open economies need more reserves than those where foreign trade is less important; and those with a fixed currency, such as China, need more reserves than those with a floating one.

Reserves are particularly important for emerging economies. As these countries open up to foreign capital, they need relatively more reserves. That was one painful lesson of the 1997-98 Asian financial crises, when several emerging Asian economies turned out to have insufficient reserves given their level of short-term foreign debt.

After these crises, Asia's emerging markets rapidly built up their arsenal of foreign exchange. According to an analysis in the IMF's latest *World Economic Outlook*, this build-up was justified by economic fundamentals until about 2001. Since early 2002, however, reserves have rocketed and are now unnecessarily high.

The suspicion, therefore, is that Messrs Fukui, Zhou, Fai-nan and company have been buying dollars for nefarious reasons: to keep their exports artificially cheap and hold on to their traditional export-led growth. Exports now make up 64% of the region's GDP, up from 55% in the early 1990s. Asians seem to like it that way. Yusuke Horiguchi, chief economist of the Institute of International Finance and former top Asia expert at the IMF, talks of a “deeply rooted mercantilist instinct” in Asia “with an almost religious attachment to trade and current-account surpluses”.

But this passion for trade surpluses is not without its problems. Not only does it prevent Asians from playing their part in rebalancing demand away from America, it also contravenes the rules of world trade. The charter of the IMF prohibits a country from manipulating its currency to “gain an unfair competitive advantage” over its trading partners.

The definition of manipulation includes protracted large-scale intervention in one direction in the exchange markets. That sounds suspiciously like what the Asians have been doing. Unfortunately there is no simple answer, because all the countries' problems are different.

Japan is by far the region's biggest economy. Unlike the others, it is a rich industrial country which has been running a current-account surplus since 1981. It already has the largest dollar reserves in the world, and is accumulating more at a rapid clip. All this suggests that Japan should take the biggest share of any dollar adjustment in Asia. Yet, as the previous section explained, the country suffers from chronic deflation. A sharp appreciation in its currency right now could undermine any hope of boosting growth in the short term. On balance, therefore, most analysts have concluded that a boost to Japanese demand will be more helpful to the world economy than a stronger yen. On economic grounds that is the right choice, but politically it will make it harder to persuade other Asian countries to let their currencies appreciate.

Collectively, the other dollar-buyers in Asia pack an even bigger economic punch than Japan. China, South Korea, Taiwan and the region's other emerging economies together account for 20% of world trade, compared with Japan's 5%. Their combined current-account surplus in 2002 was $133 billion, larger than Japan's ($113 billion) or the euro zone's ($72 billion). That is why they must play a big part

in any global economic adjustment.

China, in particular, is crucial. Leaving aside Japan, it is the region's giant, with by far the fastest-growing economy and the biggest stash of reserves. Most Asian countries are terrified that China will beat them on every product, so no country will allow its exchange rate to rise unless China's does too.

China's currency, the yuan, has been fixed at 8.3 to the dollar since 1994. In the late 1990s China's fixed currency won it many plaudits. As other currencies in Asia succumbed to financial crises, the yuan remained stable (appreciating sharply against the rest of Asia). China was credited with preventing a round of dangerous competitive devaluations.

Now, however, China's attachment to its fixed rate generates hostility. After years of fast growth and huge inflows of foreign investment, claim the critics, the yuan should be stronger. Instead, as the dollar has fallen over the past 18 months, the Chinese currency, in effect, has fallen with it. Clearly, they say, the yuan is undervalued.

In evidence, they point out that, according to economic theory, exchange rates in countries with rapid productivity growth should be appreciating. China's economy has been growing much faster than the rest of the world, and its current account has been in surplus since 1994. For a fast-growing emerging economy with high levels of investment, a current-account deficit would be more normal. Moreover, capital is pouring into China. Last year it was the world's largest recipient of foreign direct investment, with inflows totalling $53 billion. Like trade surpluses, large capital inflows should push up the currency. Lastly, the huge and accelerating build-up of reserves suggests that, left to its own devices, the yuan would appreciate.

Estimates of the degree of undervaluation differ wildly. According to *The Economist*'s informal measure of currencies, the Big Mac index, the yuan is undervalued by a whopping 56%. Ernest Preeg, an economist at America's Manufacturers Alliance, argues that if normal market forces applied, the yuan would rise by 40%. A recent study by UBS, a bank, put the figure around 20%. Others reckon it might be only 10-15%.

The problem is that traditional gauges of undervaluation do not work well in an economy with tight capital controls and in the midst of colossal structural changes. Nobody can be sure that China's currency really is grossly undervalued. And if it is, it may not remain so for long.

For a start, the scale of China's current-account surplus is frequently exaggerated. Many Americans think it has a huge overall surplus when in fact it has a large, and rising, bilateral trade surplus with America, which is now bigger than Japan's bilateral surplus (see chart 12). China's overall current-account surplus, on the other hand, is much smaller than Japan's, and is shrinking fast. In the first few months of 2003, China's trade balance was actually in deficit.

This may reflect temporary factors: higher oil prices in advance of the Iraq war, and a one-off surge in imports delayed to take advantage of tariff cuts introduced on January 1st. But it may also reflect a longer-term trend towards higher imports of capital and consumer goods. China's imports have been growing at an annual rate of over 40% a year recently, even faster than its exports (30% plus). Many of those imports are inputs for exports, but not all. According to Nicholas Lardy, a China expert at the Institute for International Economics, there are signs that imports are being fuelled by rising domestic demand. Car imports, for instance, are up more than 60% on last year. The big tariff cuts associated with China's entry into the WTO may push up import growth even further. If Mr Lardy is right, and China's imports are set to grow rapidly even at the current exchange rate, the case for a large appreciation looks weaker.

Evidence from the capital account must also be treated with caution. Yes, China has recently been the world's biggest recipient of direct investment, but according to Mr Lardy, many capital inflows have been speculative, and might easily reverse themselves. Chinese companies, expecting a revaluation of the yuan, are bringing home money that they had illegally stashed abroad. Mr Lardy reckons that these “unrecorded inflows” make up a big share of the recent rise in reserves.

Those who call upon China to revalue also point to its highly controlled capital account and its distorted financial markets. A good dose of deregulation, they say, would break China's mercantilist plot. But they may be overstating their case. One result of China's capital controls is that its citizens and firms cannot legally keep their money abroad, but must entrust it to the country's troubled banking system. According to many China watchers, this means there is a huge pent-up demand for foreign assets.

Andy Xie, an economist at Morgan Stanley, points out that Hong Kong residents hold an average of $30,000 each in foreign currency, whereas in mainland China the figure is a mere $100. If Chinese residents could hold more dollars, he argues, they would. Mr Lardy says that the distribution of deposits in Chinese banks is highly skewed. A small number of rich people account for a huge share of total deposits. These richer, more sophisticated Chinese, he argues, would quickly shift to dollars if they could, so that whenever China gets round to loosening its capital controls, it could see big capital outflows. The yuan might even fall, not rise.

In short, it is hard to determine whether the yuan is undervalued today. It is even harder to determine how far, and in what direction, it should move in future as China becomes more integrated into the world economy.

There is a much clearer argument for making China's currency more flexible. A flexible exchange rate would allow the yuan to move as capital and trade conditions shifted, and would give the government the monetary autonomy to deal with economic shocks. And indeed, China says it is gradually moving towards a more flexible exchange-rate regime. But there are few signs that this is really happening. The government is deeply worried about the instability that might result. For some years it has derived its legitimacy, such as it is, from the country's continuing economic boom. It fears that meddling with the currency could raise unemployment, aggravate deflationary pressures and cause a meltdown in the banking system.

Many of these fears are overblown, especially those about deflation. True, prices in China until recently were falling slightly, but much of that has to do with huge productivity improvements and excess capacity in state-owned firms, not with overall economic stagnation. It is hard to see how an economy growing at more than 7% a year can face a Japan-style deflation problem.

The price of stability

A fixed currency may bring stability, but at a price—to China as well as to the world economy. Part of that price is the returns forgone when the Chinese authorities pile up mountains of reserves: they are holding low-yielding American government debt rather than investing the money more profitably at home. There is also the risk of financial distortion. As Alan Greenspan recently pointed out, China's accumulation of reserves will eventually distort its monetary system. As the central bank builds up reserves by buying dollars, it must pay out yuan. Either this growth in the money supply is sterilised—which means selling domestic bonds to mop up the excess liquidity, an increasingly expensive process—or domestic liquidity will rise rapidly, which could overheat the economy and cause financial bubbles. Domestic credit has already been soaring (relative to GDP, it was up 38% in the first half of 2003), leading to isolated property bubbles and a string of financial scandals. The longer this continues, the higher the risk of large-scale financial bubbles.

To avoid this, China's government has been trying to reduce pressure from the reserve build-up, but without touching the yuan. It has slightly relaxed restrictions on residents' purchases of foreign currency; allowed firms to keep a bigger share of their foreign-exchange earnings; and announced plans to allow some Chinese firms to buy foreign bonds and stocks from later this year. These tentative steps towards a more open financial system are worth taking. But they should be accompanied by a move towards greater flexibility of the currency system.

This need not mean an immediate floating of the yuan. The currency could float freely only if capital controls were substantially lifted. Given the parlous state of China's banks, such a big bang would be far too risky. A main lesson of the Asian crisis, after all, was that financial opening needs to be handled carefully.

Nor does re-pegging the yuan at a higher fixed rate seem a sensible option. For a start, nobody really knows how much the yuan should rise, if at all. Besides, a new peg would do nothing to prepare the exchange-rate regime for dealing with future economic shocks.

The best thing China can do—both for its own economy, and to help global economic adjustment—is to tie the yuan to a broader basket of currencies, including the euro, and widen the band within which it can move. Increasing the wiggle room would allow the yuan to appreciate, making the global adjustment a bit easier. And by broadening the basket of currencies, China would ensure that it did not simply follow the dollar when, as this survey predicts, the greenback heads down further.

Drag the others along

If China were to move to a more flexible currency regime, the chances are that other emerging economies in Asia too would let their currencies move within wider margins. These countries do not face the risk of sudden capital flight or financial-sector collapse. Unlike China, they have relatively sophisticated financial systems and freer capital flows, which suggests that they are better placed to cope with stronger currencies. Politically, however, any movement without China is impossible. China is not just perceived as a competitive threat by many Asian economies; it is also their biggest export market.

In sum, the safest outcome in the next couple of years for emerging Asia, as well as for the global economy, is not a huge jump in exchange rates, but a gradual strengthening. The world economy will still be relying on Messrs Fukui, Zhou, Yam, Fai-nan and Seung to buy dollar assets, but not quite so many of them.

If, on the other hand, China's leadership does nothing about the yuan, protectionist pressures may become irresistible, particularly in America. That would be a disastrous outcome, for China as much as for everyone else.

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Raising the barricades

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From The Economist print edition

If the global economy falters, free trade will suffer

"I'M MAD as hell," roared the man on stage. "Mad as hell about what is happening to the manufacturing sector in America.""This is a trade war with China," shouted his colleague, "and it's time to fight that war head on."

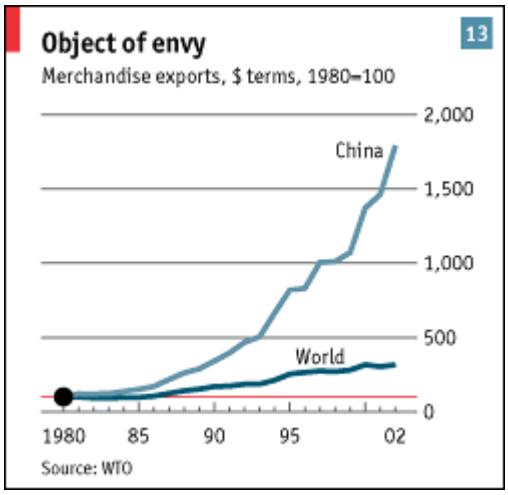
The audience cheered in approval. Patriotic songs played in the background, interspersed with extracts from George Bush's address to the nation after September 11th. Banners waved. "Leave China in the sink," said one. "Free trade is a myth," said another.

This was August 1st, dubbed Manufacturing Awareness Day in Connecticut by a new anti-China trade group called "Mad in USA". In recent months, several such grassroots groups have sprung up across America's manufacturing heartland. They represent mainly smaller businesses (big firms are buying from China, or moving their manufacturing there), and promote a mixture of protectionism and patriotism. On the website of "Save American Manufacturing", a Wisconsin-based group, a cartoon Uncle Sam urges you to "join the fight to stop the de-industrialisation of the United States".

As yet these groups are small, but China-bashing is a growing phenomenon. With 2.7m manufacturing jobs—one in six—lost during the past three years, people are looking for a scapegoat. Japan served in that capacity when its trade surplus with America was soaring in the 1980s; now it is China's turn.

Over the summer, complaints about China have become a big political issue in Washington, DC. Congressional committees have held hearings about unfair competition from China, and particularly its cheap currency. Mr Bush's rivals sense a winning issue. Joseph Lieberman, a Democrat contender and supposed free-trader, has accused China of "economic attack". Mr Bush's economic team is worried that the China issue will escalate as the election nears, particularly if the jobs outlook remains glum.

They are right to be concerned. The political backlash in America is likely to gain momentum as China's role in the global economy becomes ever more prominent (see chart 13). This is not a temporary blip that relies on a cheap currency. It is a structural shift based on economic reform, huge reserves of cheap labour and a rapidly improving infrastructure.



China's integration promises vast benefits for the global economy, but it comes at an awkward time. During the 1990s, protests against globalisation, though vocal, were relatively ineffective. Political pressure for protection in rich countries was subdued as economies boomed. Now, with weak economic growth and higher unemployment, the potential for protest is much greater. The loss of blue-collar and, increasingly, white-collar jobs is more keenly felt as firms outsource or move their factories abroad. In poor countries, too, the "China threat" seems more acute when export markets are weak.

And there are more China-related shocks on the way. At the end of 2004, the Multifibre Arrangement, a quota system that has governed, and distorted, the world textile market for decades, is scheduled to expire. Apart from agriculture, textiles and clothing are among the last products where governments rather than markets determine trade patterns. China, with its army of low-paid workers, will be a big winner from the demise of this regime. According to Mr Lardy, its share of the American clothing market, for instance, could zoom up from 12% in 2002 to 30% once restrictions are lifted.

America's small but highly protectionist and politically sensitive textile industry will be hurt, and will shout. But it is other developing countries that will feel serious strain. Textile production is the first rung on the manufacturing ladder for many poor countries. The quota system has guaranteed such countries access to America and other rich-country markets. Without quotas many will lose out to China. Their protests will coincide with rising anti-China sentiment in American manufacturing, creating an atmosphere in which protectionism could flourish.

America's government has plenty of tools to use. Under the terms of China's entry into the WTO, a number of “safeguards” allow countries to slap tariffs on Chinese goods if they are deemed to be causing “market disruption”. These temporary safeguards can be used for all goods until 2014. For textiles there are additional, even more broadly defined safeguards that apply until 2008.

So far the Bush administration has shown remarkable restraint in their use. Of a handful of safeguard applications filed by American industries, two have reached the White House: one by American producers of pedestal actuators (devices used in, eg, electric wheelchairs) and another by American producers of wire coat hangers. Both were turned down.

One reason for the restraint is a desire to maintain cordial relations with China, not least for geopolitical reasons. Since September 11th the Bush team has courted China as an ally in the war against terrorism. Its help is particularly crucial in dealing with North Korea. But as the election looms, domestic political considerations will play an increasing part. The Bush team has jettisoned its free-trade instincts in the pursuit of votes before, and may well do so again in 2004. Many trade-watchers in Washington fear the introduction of a mass of safeguards and anti-dumping tariffs, and a rapidly souring economic relationship with China, especially if there is no movement on the yuan.

Nor is China the only area where trade spats are likely to intensify. The transatlantic trade relationship, too, will see more disputes, particularly if the euro rises. An appreciating euro will put European industry on the defensive, though that defensiveness is unlikely to translate into a flurry of anti-dumping and safeguard actions. Europe's trading relations are handled at the level of the European Union, not individual countries, which makes Europe's trade policy less litigious than America's. The hurdles that a European firm must clear to persuade the European Commission to press an anti-dumping case are much higher than those faced by an American firm.

That does not mean Europeans are less protectionist; simply that the tactics are different. There may be political pressure in Europe to enforce rulings the WTO has already made against America, notably in the case about America's foreign-sales corporation tax, a tax break given to American exporters. The WTO has ruled that the American tax break was an illegal export subsidy and given the Europeans permission to levy up to $4 billion in retaliatory tariffs. So far they have held off, waiting for America's Congress to rewrite the offending parts of the tax code. But it is far from clear that such a change will actually be passed. The chances are that the dispute will rumble on, and pressure in Europe for retaliatory tariffs may rise.

Americans, for their part, increasingly view Europe's regulatory requirements—ostensibly designed to protect consumers or the environment—as a form of protectionism through the back door. One example is the continuing row over genetically modified crops. America has threatened to appeal to the WTO over the moratorium the Europeans have imposed on approving GM crops. American producers reckon that even assuming the moratorium is lifted, Europe's new labelling requirements for GM products are too onerous and protectionist.

A potentially even bigger fight looms over Europe's proposed regulations on chemicals, which require manufacturers and users of chemicals to give extensive information on the health and environmental effects of all their products. Here, too, Americans smell European protectionism.

After Cancun

Set beside the huge importance of the transatlantic trade relationship, each of these issues is an irritant rather than a threat. There is little risk that transatlantic trade will be engulfed by a wave of protectionism, even if the dollar plummets. But at a time when economies are already fragile, such trade spats add unwelcome political tensions. More important, after the collapse of last week's WTO ministerial talks in Cancun, they make it even less likely that the Doha round of global trade talks can be revived.

The Doha round, launched soon after the September 11th attacks, has ambitious goals, geared

particularly to helping poor countries. Dubbed a development round, it aims to free up farm trade, long the sacred cow of global protectionism; slash remaining tariffs on industrial goods; and liberalise trade in services. The potential benefits for the global economy, and especially for poor countries, would be considerable. According to the World Bank, a successful Doha round could raise poor countries' income by $350 billion a year and lift 144m more people out of poverty by 2015.

These gains are now in serious jeopardy. Last week's ministerial summit in Cancun—which was supposed to mark the mid-point of the round—collapsed in disarray on September 14th, with rich and poor countries unable to agree about the scope and ambition of the Doha round. Poor countries, particularly African ones, refused to extend the negotiations into new areas, and accused the rich countries of refusing to make serious efforts to dismantle their egregious farm subsidies. Negotiations are to continue in Geneva, but the official deadline for finishing the talks—December 31st 2004—now looks certain to be missed.

At first sight, that should not matter too much. Experience shows that trade rounds always drag on much longer than planned. Doha's predecessor, the Uruguay round, took eight years to complete, rather than the three originally scheduled. But this time is different. The WTO, an organisation already short on credibility, has been dealt a body blow. Moreover, the environment in which the talks take place is likely to become increasingly hostile to freer trade. Europeans, under pressure from an appreciating euro, will find it harder to sell more farm reform at home. Poor countries, worried about China, will become even more leery about lowering their own barriers. America, with its growing trade deficit, will find it ever harder to argue for free trade. And the president's fast-track negotiating authority—under which Congress can approve but not alter trade agreements—runs out in 2007. If the mood in Congress turns against trade liberalisation, the authority may not be renewed.

These risks are not lost on Mr Bush's trade team. They are one reason why Bob Zoellick, America's top trade man, is a strong proponent of “competitive liberalisation”. America is simultaneously negotiating global, regional and bilateral trade deals because the momentum has to be kept going. Engaging Congress in new trade deals, he says, stems the slippage towards protectionism.

Underlining his point, President Bush has just signed free-trade agreements with Chile and Singapore. In the past year, the Bush team has initiated bilateral trade deals with all the Central American countries and five countries in southern Africa, as well as Morocco and Australia. It has also promised to start trade talks with Bahrain and the Dominican Republic. More are likely to follow. After the failure of the Cancun talks, Mr Zoellick said that America would now push on the bilateral and regional route.

Bilateral trade deals, particularly with small countries, are much easier to get through Congress than multilateral ones. But success at bilateral trade deals coupled with a lack of progress on the Doha round would gradually create a different kind of global integration. From an economic perspective, a spaghetti bowl of bilateral trade agreements is much less desirable than progress towards multilateral free trade. Moreover, America's choice of bilateral free-trade partners so far suggests politics plays as much of a role as economics in defining the administration's agenda.

Already free-traders argue that America is interested more in economic “coalitions of the willing” than in global free trade. Jagdish Bhagwati, an economist at Columbia University and a vocal free-trader, says America's behaviour is that of a selfish hegemon. The country's appetite for bilateral deals, he claims, is undermining the global trading system. That is unfair, because the Bush team has worked harder than many others to make progress on the Doha round. Certainly the Americans share some of the blame for the collapse at Cancun. Their unwillingness to offer poor African countries more concessions on cotton was particularly unhelpful. But poor countries' intransigence was just as much of a problem.

Whoever bears the responsibility, though, bilateral trade deals are no substitute for progress towards multilateral free trade. On current trends, depressingly, it seems that the global trade system is heading for second-best.

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Leadership and luck

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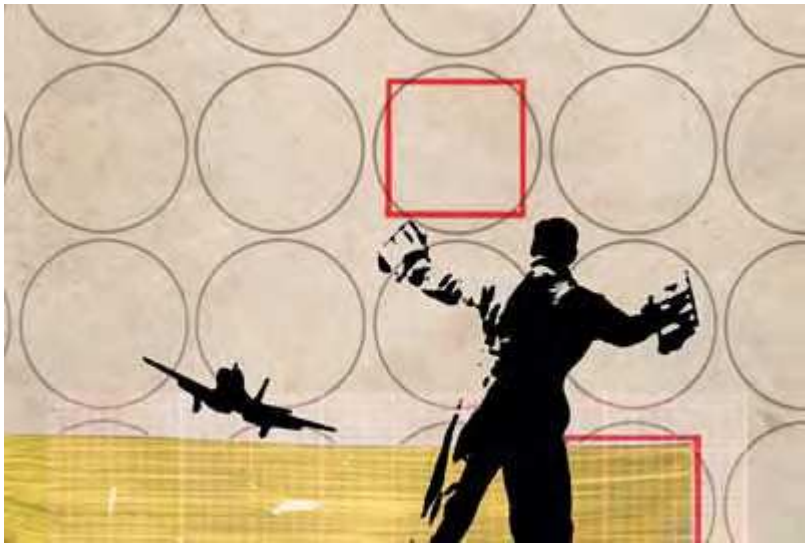

The world economy needs both

TO GET a sense of the challenges facing the global economy, fast-forward four years to September 2007 and consider the following three scenarios:

•The world's top finance ministers arrive in Washington for an emergency summit after the dollar has crashed and financial markets have seized up. Foreigners are deserting American assets following the announcement of a $50 billion derivatives loss at Fannie Mae, America's mortgage giant. Bond yields have soared three percentage points in two weeks; the dollar is down 40% over the same period. Several large banks are rumoured to be on the brink of collapse.

•With America's trade deficit topping $800 billion and the budget deficit close to 7% of GDP, Congress is in a protectionist frenzy. A bill sponsored by Hillary Clinton, the leading Democrat contender for the presidency in 2008, to impose a 25% surcharge on imports from all countries with large trade surpluses looks set to pass. More radical legislation calling for America to leave the WTO is gaining support.

•After six years of poor growth, America's economy has been widely written off. The dollar is weak, and the administration is preoccupied with painful budget cuts. Top of the business bestseller list is a new book by Lester Thurow called “A Haemorrhaging Hegemon: How America's Economy Owned the '90s and Flunked the Millennium”. Attention has shifted to Europe, where productivity and investment are soaring. China remains the world's most buoyant economy, but Japan, too, is growing at a fair clip, catching up after a decade of stagnation.

Of course these scenarios are flights of economic fancy, but they make two serious points. First, the world's reliance on America as its only engine is increasingly risky. Second, moving away from a one-engined world will not be painless. In America, in particular, the economy is likely to remain weak for the next few years. That may sound depressing, but sluggish growth for another half-decade is much better than a dollar crash, a deep recession or a stampede into protectionism.

A sudden dollar crash precipitated by a big shock in America's financial markets may not be likely, but it is certainly possible. The longer that America's current-account deficit—and hence its reliance on foreign capital—continues to grow, the greater the risk that a shock to America's financial markets will send the dollar crashing. This would probably push the world economy into recession. Spiking interest rates would deflate American consumer spending. A soaring euro would darken Europe's economic outlook. If the euro rose far and fast enough, it might even put European monetary union at risk. And poor countries

would be hit by a double whammy: a sharp drop in export earnings as the rich world plunged into recession, and a sharp rise in interest rates as investors abandoned risky assets.

Protect us from protectionism

But a dollar crash and global recession are not the only gloomy possibilities. Equally worrying, and much more likely, is a surge in protectionism, especially if America's current-account deficit continues to rise rapidly. In 1985, Congress seriously considered an import surcharge of the sort described in the imaginary scenario above. Many American politicians are already ambivalent towards the WTO. If the government loses a few more big trade cases, that ambivalence could turn to antipathy.

A slide into protectionism would have grave consequences. Since the end of the second world war, America has championed the multilateral approach to freeing global trade, though with varying enthusiasm. If it were to give up this leadership role, even temporarily, the global trading system would be in deep trouble. The WTO is a fragile organisation, less than ten years old. It would not survive a lengthy period of American disengagement.

The intellectual consensus in favour of free trade, particularly in poor countries, could also wither in the face of American protectionism. Poor countries would ask why, if it was fine for America to raise barriers against the Chinese threat, they should hold back from doing the same. Given that trade integration plays a crucial role in economic development, the world's poorest would find it that much harder to escape from poverty.

The most important message, however, comes from the third and most optimistic scenario. It is that the best outcome the world economy can hope for in the next few years is a fairly sluggish performance by America's economy, combined with faster growth elsewhere. A few more years of below-average growth but no serious recession would help America to work off its excessive debt and increase its savings rate. The best-case scenario would be for both Europe and East Asia simultaneously to pick up the slack. That would allow the dollar to decline gradually rather than crash; but with relatively slower growth at home and faster growth abroad, America's current-account deficit could be trimmed sharply. Just when Mr Thurow published his book on hegemonic decline, America would be set to prove him wrong (once again). With the imbalances worked off, its highly productive and flexible economy would be ready to roar.

Sadly, the chances of such a gradual adjustment are not good. The trend remains towards ever bigger American imbalances and continued reliance abroad on American economic growth. European and Japanese leaders seem to take this for granted, much as they rely on America's security umbrella. Reversing that attitude, and with it the trend towards ever bigger American indebtedness, will take political leadership as well as a large dollop of luck.

Yet to judge by their rhetoric, today's politicians have little sense of the mess that the world economy is in. The Bush administration does not even acknowledge that there is a problem. Europe's leaders are too busy squabbling over who has broken the Stability and Growth Pact's 3% deficit target to see the global economic picture. And Japan's politicians spend too much time bad-mouthing China and too little offering solutions to their own economic troubles.

This must change. The Europeans and Japanese need to understand that they are not only facing a demographic hiatus of their own, they are also operating in a global economy that could come seriously unstuck unless they act soon. China's leaders, too, need to make the connection between their own economic policy and the global picture. Unless they loosen their dollar peg soon, they will find the protectionist backlash against them will get a great deal worse.

The heaviest responsibility to act differently, however, falls on America itself, which is as guilty as anybody else of causing the world's current lopsidedness. And until Mr Bush's economic team acknowledges the size of the problem, others will hide behind American nonchalance.

In the 1980s, the turning point came when James Baker, Mr Reagan's Treasury secretary, acknowledged the global imbalances and recognised the risks involved. He instigated the Plaza Accord not out of an idealistic commitment to the global good, but because the global imbalances imperilled America's own prospects.

Mr Bush's current team need not—and, as this survey has argued, probably could not—replay the 1980s.

But as in the Reagan days, it must force the world to recognise the need to adjust. If America does not lead in global economic policy, no one else will. And if nothing is done, the imbalances will worsen and the dark scenarios of financial crashes or protectionism become ever more likely.

America's biggest contribution to shifting the world away from one-engined growth—and towards improving its own economic prospects—would be some serious medium-term fiscal belt-tightening. The country's dramatic shift into budget deficits may have underwritten the American, and thus the global, economy in the short term, but it risks making the medium-term problem much worse. Bigger American budget deficits mean bigger current-account deficits and an ever greater American reliance on foreign funding.

Worryingly, Mr Bush's deficits show no sign of being temporary. The president's tax cuts have not yet been fully phased in, and numerous accounting gimmicks have been used to massage down their apparent cost. The official estimate of the cost of the latest tax cut is $350 billion over ten years, but most budget-watchers put the real figure at twice that level. Nor is the government merely aiming to give the economy a temporary fillip; its declared intention is to reform America's tax code and entirely eliminate the taxation of investment income. That suggests there are more tax cuts to come.

Spend, spend, spend

Yet there is scant sign of any spending discipline to match the lower tax revenue. Despite his rhetoric to the contrary, Mr Bush has proved himself to be no Scrooge with federal dollars. On his watch, federal spending has soared by more than 20%. Only part of that rise can be explained by higher spending on defence or homeland security.

Defence spending, though, is heading ever higher, according to estimates by Steven Kosiak at the Centre for Strategic and Budgetary Assessments. He reckons that adding together Mr Bush's grand plans for military modernisation and existing commitments in Iraq and Afghanistan, the defence budget over the next decade will increase by nearly $700 billion more than assumed in Mr Bush's budget projections.

And there is more. Mr Bush's planned expansion of Medicare, America's health-care programme for the elderly, to include prescription drugs, will supposedly cost $400 billion over the next decade. But most health-care experts—and privately some economists within the Bush administration too—expect the real bill to be much higher. Far from reforming America's entitlement programmes as baby-boomers head for retirement, Mr Bush is expanding them.

The risks of these policies have not gone unnoticed in Washington. Democrats have been bemoaning the rise in deficits a decade before the ranks of pensioners are due to swell. Still, it has all seemed a long way off. And yet if this survey proves right, America's budget deficit could cause big problems long before the baby-boomers start retiring.

American policymakers' main responsibility, therefore, is to improve the medium-term fiscal outlook. The budget rules that forced discipline on spending and tax-cutting plans during the 1990s must be revived. The Bush team must put forward detailed proposals for controlling Medicare costs. The spending frenzy must be controlled and the tax-cutting momentum slowed, perhaps even reversed.

If America acknowledged both the danger posed by global imbalances and its own responsibility for reducing them, putting political pressure on others to play their part would become much easier. In continental Europe, the pressure should be least necessary. For the policy recipe that is best for Europe is also best for the world economy: determined structural reforms coupled with a sensible (read looser) macroeconomic policy.

In Asia there is a greater tension between the short-term domestic agenda and what the world economy needs. China, as this survey has argued, must break the paralysis on its exchange rate and gradually move towards greater flexibility. To support that shift, the Bush team must beat back domestic China-bashers but keep up the pressure on the Chinese government for gradual change. At the same time China and America together must push other emerging Asian economies to follow suit.

In Japan, in the short term, the trade-off between domestic requirements and global responsibilities is even more difficult to judge. The global economy needs a stronger yen; the Japanese economy does not. But if the government were to begin serious financial-sector reform and simultaneously to reflate the economy, the contradiction would soon disappear, and the yen would strengthen without undue risk to

the domestic economy.

If America shows the necessary leadership, and others live up to their responsibilities, there is still time to replace the one-engined global economy with a safer model. But if nothing changes, get ready for a crash landing.

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Sep 18th 2003
From The Economist print edition

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Mobile telecoms

The shunning of 3G

Sep 18th 2003
From The Economist print edition

Europe's first fully fledged 3G operator is struggling. So is 3G doomed?

Get article background

EVERYONE in the mobile-phone industry is watching 3, a new operator owned by Hutchison Whampoa of Hong Kong, which is setting up third-generation (3G) mobile-phone networks in several countries around the world. 3G is faster than existing 2G technology, with the potential to offer whizzy new services such as sending and receiving live video. In March, 3 launched Europe's first commercial 3G service in Britain and Italy. Since then it has launched networks in Australia, Austria and Sweden, with Hong Kong and Denmark expected to follow soon.

It is 3's operations in Britain and Italy, where it has nearly all of its customers, that are being followed the most closely. Having collectively paid over *euro*100 billion ($112 billion) for their 3G licences, Europe's other operators are hoping to learn from 3's experience as they prepare for their own 3G launches. For 3 is pioneering a 3G technology, known as W-CDMA or UMTS, to which European operators, and some of their counterparts in Asia and America, have also committed themselves.

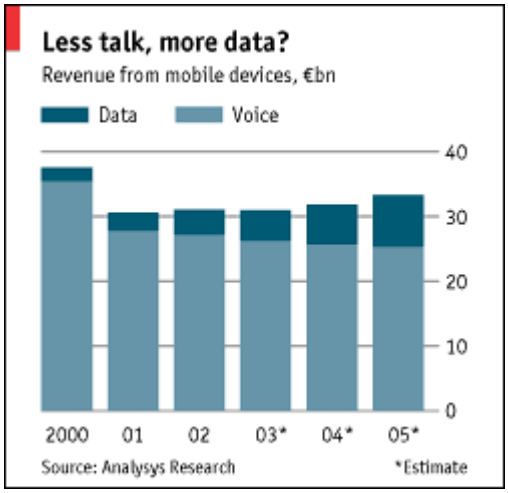
So far, things do not seem to be going well. Despite a huge advertising campaign promoting the video capabilities of 3G handsets, consumers seem unimpressed. Six months after launch, 3 has signed up 300,000 subscribers in Italy and 155,000 in Britain, and seems unlikely to reach its target of 1m users in each country by the end of the year. Subscribers complain of lost calls, bulky handsets and inadequate battery life. Some are still carrying their 2G handsets around with them as back-ups.

Things look particularly bad in Britain, where 3 has had to cut prices already to drum up business. A new tariff introduced in June offers subscribers 500 minutes for £25 ($40) per month—far less than the incumbent 2G operators, which typically offer 400 minutes for £45. This week, 3 introduced lower tariffs in Sweden too. What is worrying is that the chief justification for 3G has long been that it would enable lucrative new data services, such as video and high-speed internet access, to compensate for declining revenues from voice calls, which are being eroded by fierce competition. If cheap voice, not pricey data, turns out to be the only way to interest customers in 3G, is this plan doomed?

Not necessarily. For unlike the vast majority of Europe's operators, 3 is a “green-field” operator that does not own an existing 2G network. This makes 3 an unreliable crystal ball with which to predict 3G's future, because it has been forced to launch, market and price its service in a different way from other, established operators.

For a start, 3 decided to launch 3G before the technology was really ready, in an attempt to steal a march on its rivals—most of whom will launch next year. Hence the technical gremlins, as handsets and base-stations made by different firms do not yet work together well. 3's marketing also stressed gee-whiz technology, as that is the basis of its competitive edge over 2G operators. 3 only resorted to price cuts once it became clear that video-telephony, its main differentiator, had failed to catch on. “Video was all they advertised, but now it is cheap voice,” says Brian Modoff, an industry analyst with Deutsche Bank.

Talk is cheap



Whether this is a viable strategy remains to be seen. Technological improvements allow voice calls to be carried more cheaply on new 3G networks than on existing 2G ones, so 3's decision to undercut its 2G rivals makes sense. In saturated markets, 3 can only sign up new customers by tempting them to defect from other operators. So far, fears that other operators would follow suit have proved unfounded. They would sooner lose a few subscribers to 3 than drop their prices.

Instead, established operators are introducing 3G a different way. This summer they have aggressively promoted bundles of mobile data services, including news updates, games and the ability to send still photos (but not live video). Such services can be delivered to new handsets with colour screens, via today's enhanced 2G, or 2.5G, networks. Vodafone's data-service bundle is called “live!”, T-Mobile's is called “t-zones”, O2's is called “Active”, and so on. But the capacity of 2.5G networks is limited. So as more users sign up and existing users upgrade, the operators will quietly switch them to new handsets that work on both 2.5G and 3G networks.

In other words, 3G will be introduced by stealth. “It has gotten such a bad name that they are not going to call it 3G,” says Mr Modoff. Instead, operators plan to emphasise their own brands rather than the underlying technology. People do not care what kind of technology they are using when they are making a phone call or downloading a ringtone, says Julian Horn-Smith, Vodafone's chief operating officer. 3G, he says, is an enabling technology, not a service, “so we won't market 3G per se.”

A far better guide to the prospects for 3G, then, is to look at how quickly data services are being adopted on 2.5G networks. The evidence looks promising. Vodafone's live! service, for example, signed up over 2m customers, primarily in Europe and Australasia, within nine months. Mr Horn-Smith says the signs are that live! subscribers spend 7-10% more than non-subscribers per month. Evidently, many people do want to use their phones for more than just voice calls and text messaging—though whether the huge outlay on 3G licences will be justified is still uncertain.

Switching stealthily over to 3G will be tricky, however, because today's 3G handsets are far bulkier and heavier than 2G ones. Operators are banking on smaller, lighter models emerging in 2004. Only then will 3G face its real test, as Europe's operators start to offer their data-service bundles over 3G networks as well as 2.5G ones. They are hoping for a smooth, seamless transition. Indeed, the irony is that if everything goes according to plan, consumers should be unaware that anything has changed. After all the 3G hype, the mark of 3G's success may be that its adoption goes completely unnoticed.

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Mobile phones

The third way

Sep 18th 2003
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As the mobile-phone software battle heats up, Motorola is hedging its bets

AFTER years of struggling to get into the mobile-phone business, Microsoft finally has a foot in the door. This week Motorola, the world's second-largest handset maker, announced that it will soon launch a new handset, the MPx200, powered by Microsoft software. This is a coup. So far, Microsoft-powered phones have been made only by obscure Asian manufacturers and have sold poorly. The news follows Motorola's decision last month to sell its stake in Symbian, an alliance it formed with Nokia and other top mobile-phone makers to provide a non-Microsoft operating system for high-end mobile phones, also known as smartphones. So has Microsoft now succeeded in getting Motorola to defect to its camp?

Not exactly. For a start, Motorola has just released its first Symbian-powered smartphone, remains a Symbian licensee, and says it will produce further Symbian-based handsets in future. And Motorola's endorsement of Microsoft's software is lukewarm: it is described as a “complement to our existing software and applications ecosystem.”

Rather, Motorola is performing a delicate balancing act. Like other handset firms, it wants to avoid the fate of PC makers, which have become commodity box-shifters while Microsoft supplies the software and creams off the profit. Hence the establishment of Symbian. But the trouble with Symbian, from Motorola's point of view, is that it is widely perceived to be unduly influenced by Nokia, which has shipped more Symbian-based smartphones than anyone else. Only by backing away from Symbian can Motorola differentiate itself from its arch-rival. At the same time, the MPx200 is a deliberate swipe at Nokia, says Ben Wood of Gartner, a research firm. “It weakens the united front of the big guys against Microsoft,” he says.

Behind these tactical moves lies Motorola's real strategy: to go its own way, powering its handsets with a combination of Linux, an open-source operating system, and Java, a programming technology that allows software to run unchanged on multiple devices. Motorola expects to launch the first handsets based on this “MotoJUIX” combination (pronounced “Motojuice”) next year.

This plan is logical but ambitious, says Mr Wood. Motorola must move fast to build software that can match the relatively mature Symbian and Microsoft operating systems, even if it has already produced a Linux-based handset for the Chinese market. Meanwhile, it will continue to make handsets based on Symbian and Microsoft software too, giving it useful flexibility in a nascent market. IDC, a market-research firm, reckons that just 14m of the 460m handsets sold this year will be smartphones, rising to 30m next year. The fight for smartphone-software supremacy has only just begun.

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Car industry pay

Deals in Detroit

Sep 18th 2003 | DETROIT
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Car firms and the United Auto Workers union do a deal in record time

AP

Ron has reason to smile

THE hoped for grand slam, industry-wide settlement failed to materialise. Even so, the United Auto Workers union (UAW) has rapidly struck separate, though fairly similar, contract deals with the Big Three Detroit car companies and two of the industry's largest parts suppliers. Instead of the usual protracted game of leapfrog, as one firm is picked off after another, a shared sense of crisis has led employers and the union, led by Ron Gettelfinger, to negotiate in a brisk, serious way.

With minor changes for each firm, the union has won a deal that staved off demands to slash medical and pension costs. Workers have also won “signing bonuses” and modest pay raises. Yet the employers have some reason to be satisfied. With their market share down, the Big Three, GM, Ford and Chrysler (part of DaimlerChrysler) will now be able to close six assembly plants over the next four years.

Neither side is discussing details of the agreements. That will not happen until just before workers vote on the tentative pacts later this month. But specifics have been leaking out. The $3,000 signing bonus may seem a lot, but is actually an accounting trick to reduce the portion of wage rises counting towards retirement pay. The Big Three now have more pensioners than workers. In America, GM has two-and-a-half pensioners for every current employee.

The UAW rebuffed efforts to slash pensions and benefits, despite forecasts that such costs will bankrupt the carmakers—perhaps within the decade.

The latest release of the respected annual Harbour Report showed the Big Three improving efficiency on the factory floor, but still lagging behind the best of the Japanese-owned factories in America. Nissan's line in Smyrna, Tennessee, can build a mid-sized Altima in 60% of the time needed for the similar Chrysler Concorde. Restrictions on layoffs and plant closings have hitherto blocked further efforts by the Big Three. So the factory closures in this week's deal should certainly help to narrow the productivity gap.

Some investment analysts had feared that the industry would accept a “nothing lost, nothing gained” settlement to avoid labour strife it dreads. Though the deals will not end the productivity gap nor erase the Big Three's pension problem, says John Casesa, of Merrill Lynch, “a better relationship should lead to more flexible implementation.” If the deals go nowhere near far enough, then, they are certainly a lot better than nothing.

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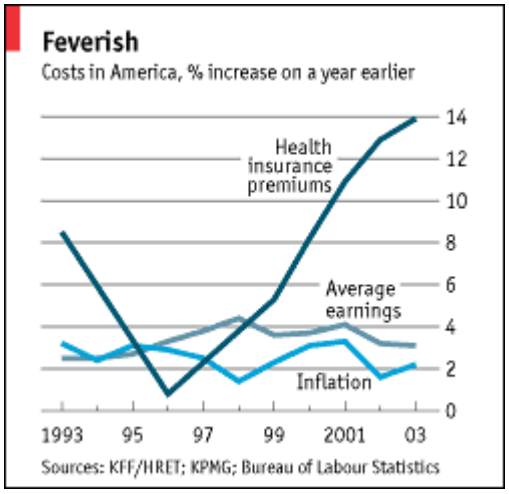
Paying for health care

Employers' liability

Sep 18th 2003
From The Economist print edition

American employers struggle with rising health-care costs



HEALTH care is expensive in America, so those workers and their families fortunate enough to be insured by employers take their benefits very seriously. Earlier this year, employees at General Electric (GE) struck, and others at Verizon protested, against proposed changes to their health care coverage. This week, however, America's car workers appear to have done an effective job of resisting change. The United Auto Workers union (UAW) reached agreement with DaimlerChrysler and Ford on labour contracts that, while yielding to the employers over plant closures and job losses, largely maintained health benefits (see article).

This is a remarkable accomplishment for the union, and a problem for car companies, according to Michael Taylor of Towers Perrin, a benefits consultancy. The car industry already pays $9,000 a year per employee for health insurance, about 50% more than the rest of corporate America. An ageing workforce and an army of pensioners compound the problem of benefits already sweeter than in other sectors, thanks to the power of the UAW.

Carmakers, like all big American employers, are struggling to cope with health insurance premiums that have risen by almost 14% on average this year, according to a recent survey by the Kaiser Family Foundation (KFF) and others. Most of the increase was to cover higher spending on hospital services and prescription drugs, due largely to tough bargaining by hospitals and a loosening of the restrictions on what employees can receive that were imposed through the shift to “managed care” in the 1990s.

Big employers are not yet reducing health benefits, or cutting back on choice for their workers, but they are trying to shift more of the cost on to the workers, through heftier co-payments for brand name drugs and doctor visits and bigger deductibles that must be paid by patients before the company health plan kicks in.

A few firms are trying a more sophisticated approach to health care, which aims to simultaneously improve health and save money, says Arnold Milstein of Mercer Human Resource Consulting. Ford, for example, has joined a pilot project on diabetes management, in Louisville and Cincinnati, giving bonuses to doctors who achieve treatment goals and rewards for employees (such as fitness club memberships) who agree, for instance, to monitor such things as blood glucose levels. With GE and 146 other big firms, Ford is part of the Leapfrog Group, an initiative to gather information on the quality of care provided by almost 1,000 hospitals for employees to use to inform their choices. The firms are also structuring their payments to reward the better hospitals.

Medtronic, a medical devices maker, is paying up to $2,000 a year per worker into a “personal care account”. Employees can spend the money as they choose, as long as it is on health care. The hope is that better information and greater personal responsibility will lead to better choices.

Even so, most big firms remain resigned to ever higher health-care bills for themselves, and to imposing higher bills on their employees as well. Although American unemployment is rising, points out Peter Kongstvedt, a healthcare consultant with Cap Gemini Ernst & Young, few big firms are willing to risk losing good people by trimming health benefits too far.

Nor does the government, faced with mounting medical bills, want employers to cut their provision. One

stumbling block in Congress to devising new legislation to meet the cost of prescription drugs for America's elderly Medicare population is the danger that it would prompt firms to end the prescription-drug benefits they now give to retirees. Firms have already reduced their cover for retired workers. According to the KFF survey, less than 40% of big firms questioned now offer their pensioners health coverage, down from two-thirds in 1988. Congress is now scrambling to find ways to encourage more corporate largesse, including tax credits and other subsidies. But there is no cure in sight for America's health-care crisis.

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Airlines

Global pattern

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Air France's alliance with KLM reveals a new industry pattern

AFP

Love birds

AIR FRANCE is in advanced negotiations with KLM Royal Dutch Airlines with a view to “intensive co-operation”, although “critical points” were still under discussion, the two airlines confirmed on September 17th. Shares of KLM have been soaring in expectation of the two carriers announcing some sort of marriage.

Most countries ban cross-border airline mergers. International traffic rights are tied to designated domestically-owned carriers under bilateral government deals. So a full merger is hard to do. Ideally, the carriers would form a jointly-owned company with the KLM brand kept alive as a Dutch subsidiary exercising the international traffic rights from the Netherlands. But the Dutch carrier tried twice to tie up with British Airways, in 1991 and in 2000, only for talks to break down over British Airways's refusal to pay what KLM asked for a non-controlling stake. The same concerns may well rule out a full merger of KLM and Air France.

More likely is a looser tie-up. KLM will join the global SkyTeam alliance of airlines, based around Air France and America's Delta Air Lines. Under that umbrella, KLM and Air France will pool flights, co-ordinating schedules and prices as much as is allowed by European Union (EU) competition authorities. There may even be symbolic exchanges of equity stakes. British Airways and Lufthansa are watching closely, and can be expected to complain if integration goes too far. Air France has also recruited Alitalia to the SkyTeam group, which will now rival the other two global alliances, Star (Lufthansa, United Airlines, Singapore) and oneworld (British Airways, American Airlines, Cathay Pacific) in terms of traffic.

Alitalia and KLM had no choice but to seek salvation as junior partners in big alliances: both are weak, indebted and have been hurt by the recent aviation slump. KLM had held talks with Alitalia about joining forces, and for the past year had been weighing up whether to throw in its lot with oneworld or with SkyTeam. The now-receding possibility of America's United being liquidated, thereby destabilising all three big alliances, delayed the decision for much of this summer.

Since 1989 KLM has had an increasingly close alliance with America's Northwest Airlines. This is a deeper

integration than in any other alliance: for instance, KLM does all the marketing for pooled transatlantic flights in Europe, while Northwest markets them in America. Separately, Northwest has a marketing alliance with both Continental and Delta for domestic American flights. Northwest bosses have been very supportive of KLM's bid to team up with Air France and SkyTeam, and want to join SkyTeam, too. Then, probably, Continental will follow suit.

Airline mergers within America are also hard to do because of the intense antitrust scrutiny they draw (largely because airlines have dominant shares of traffic at their big hubs). But the tightening web of alliances, as seen in the KLM-Air France deal, is drawing together three American carriers (Delta, Continental and Northwest) at home and abroad. Talks start next month to open up aviation between America and the EU by, for instance, loosening national ownership rules—though no one expects the rapid removal of barriers to cross-border mergers. Yet global airline consolidation is already under way.

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Russian oil

Promising whispers

Sep 18th 2003 | MOSCOW
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A rumoured oil merger is a positive sign for Russia's investment climate

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WILL Russia's biggest oil firm be for sale as soon as it is born? This week the *Wall Street Journal* reported that both ChevronTexaco and Exxon Mobil were preparing preliminary bids for a one-quarter stake in the company that will be formed after two Russian firms, Yukos and Sibneft, complete a merger around the end of this year. Such a deal would be huge for Russia—worth at least $11 billion. That is twice as much as BP paid for half of another Russian firm, Tyumen Oil Company, in a deal that was completed earlier this month.

The report produced denials all round. The rumours have been circulating in Moscow for some time, however. And although any deal would have to wait at least until the merger is done, and perhaps until after Russia's presidential election in March so as to avoid making political waves, it would make sense for the two oil majors—if they are indeed interested—to start jockeying for position now.

That is because the BP-Tyumen deal raised the stakes. Having foreigners control Russia's natural wealth is politically sensitive, and most market-watchers assume that only one more such purchase will be allowed. Indeed, many now interpret the Yukos-Sibneft tie-up—which brought few obvious business benefits to either firm, since both have lots of reserves but not enough production or refining capacity—as Yukos's way of pre-empting a foreign purchase of Sibneft, thus leaving Yukos-Sibneft the opportunity to seek its own foreign buyer later.

Such a deal would certainly be good for Yukos-Sibneft, which would be able to get its oil out through a partner with world-wide distribution and refining facilities. It would also be a sign of general confidence in Russia. Yukos has come under a barrage of investigations in the past few months, apparently due to political and/or business feuds between Mikhail Khodorkovsky, its boss, and some members of the government. Similar feuds three years ago forced two other magnates, Boris Berezovsky and Vladimir Gusinsky, to flee the country and abandon many of their assets. But since the attacks on Yukos began its share price has rebounded, suggesting that investors think the company is safe, whatever happens to Mr Khodorkovsky. If a foreign oil major (or even two) takes the same view, then the business climate has clearly improved.

The benefits to Chevron or Exxon, though, are less clear cut. To be sure, both would probably like a chunk of Russian reserves. Chevron's boss, David O'Reilly, has talked about Russia as one of the firm's two key growth areas (along with the Middle East); its only big stake there now is in a pipeline. Exxon is the foreign partner in a $12-billion production-sharing agreement off Russia's far-eastern Sakhalin island. For both firms, a stake in big, relatively cheap and under-exploited (albeit often hard to exploit) oil fields would be a plus.

However, the rumoured size of the stake, 25% plus one share, is a tricky one to manage, says Adam Landes at Renaissance Capital, an investment bank. It allows the holder to block big acquisitions, mergers or break-ups, but not much else. It would have little control over things that could harm its image, such as ecologically damaging projects. It might make sense if it paved the way to buying a bigger stake later; but foreign control of Russia's oil giant might be a step that the Kremlin will not allow for many years to come.

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Sun Microsystems

The Dell of software?

Sep 18th 2003 | SAN FRANCISCO
From The Economist print edition

Sun's latest plan to convince the world that it has a future

AFP

McNealy, master of the auto analogy

“THIS is an epic announcement for the industry,” says Jonathan Schwartz, the software boss at Sun Microsystems. This week, he unveiled Sun's newest offerings to firms and governments. Chief among them is a bundle of all the software layers needed to run server computers, at a price of $100 for each employee. This is indeed radical. Other software vendors price their products per microprocessor or per data entry. Ted Schadler, an analyst at Forrester, a research firm, says that, with its “shockingly low price”, Sun is sending an unmistakable message to customers as well as to rivals such as Microsoft and IBM: software is shockingly overvalued.

As if to rub it in, Mr Schwartz then proceeded to demonstrate Sun's other new software product, an alternative to Microsoft Windows and Office on desktop computers. To oohs and aahs in the audience, Mr Schwartz dragged and flipped windows in three dimensions, then seamlessly opened documents in Microsoft file-formats, directly from Microsoft's own website (to show that he could). Sun's price on the desktop is again shockingly low—$100 per desktop, or $50 per employee for companies that also buy the new server software.

But why is Sun doing this? It is primarily a hardware vendor. In its heyday, during the dotcom boom, it barely kept up with demand for its powerful server computers. Then came the bust. It lost sales and made losses. Even a modest recovery in tech spending is not helping much. Firms have become miserly in their computer budgets. Increasingly, they are opting for cheap alternatives to Sun's sophisticated machines, such as low-cost boxes assembled by Dell that use Intel processors and run on Linux, an open-source operating system, or on Microsoft Windows.

In response, Sun has started to offer cheap servers as well, and belatedly (half-heartedly, say many) embraced Linux. Its core business, high-end servers, may never return to its former glory. Indeed, with low customer satisfaction and a failing business model, many in the industry regard Sun as a dead firm walking, destined at the very least to lose its independence in a merger.

Not surprisingly, this conventional wisdom drives Sun's chief executive, Scott McNealy, crazy. He considers the distinction between hardware and software flawed. What Sun has always sold and will always sell, he says, are “systems”. Mr McNealy, whose father worked in the car industry, and who

named his four sons after car models (Maverick, Scout, Colt and Dakota), likes to use automotive analogies. “You guys are all focusing on piston rings,” he says. “Go and ask Ford about its strategy in piston rings. And carburettors. You don't. You talk about the whole car.”

Taking the analogy further, Mr McNealy considers it insane that firms now assemble their computer data-centres as though they were making a jalopy from scratch by getting all the parts together (or, more realistically, by hiring consultants such as IBM to do it for them). Eventually, Mr McNealy believes, customers will buy complete systems, just as they buy complete cars. One day, he thinks, they will not even buy cars, but only take taxis—ie, tap into computing services through a web browser, just as many people already check e-mail through Hotmail.

As a matter of fact, most of Mr McNealy's vision is no longer as controversial as he likes to portray it. All big computer companies now agree that in future computing is likely to be sold as a utility via the internet. The issue in Sun's case is whether the firm now has the right strategy to profit when this happens.

That this question must be asked is itself a bitter irony. Sun has been preaching that “the network is the computer” since the 1980s, long before others did. And it tried always to practice what it preached by pushing open standards—if only to win points in its propaganda war against Microsoft, a firm it considers closed and evil. Its most famous open standard of all is the Java programming language that it invented in the 1990s, which has since become a hugely popular platform for software developers, from back-office servers to mobile-phone handsets and smart cards. But except for modest licensing revenues Sun has never made much money from Java's success.

So far, Sun has put on a brave face and insisted that wide acceptance of Sun software—even if open, as Java is—will somehow lead to higher sales of Sun hardware. As Larry Singer, a Sun executive, puts it, Sun pushes Java in the same way that America encourages the global spread of the English language. It is a precarious analogy. To many, Sun looks more like New Zealand pushing the use of English so that America (in this case, IBM, say, or BEA Systems, which make server software using Java) can reap the benefits.

Mr Schwartz's announcements this week are meant to fix this. They are Sun's “attempt to monetise software for the first time,” says Forrester's Mr Schadler. Sun now sees Java, a software brand, as a prime asset to be exploited. So its new server software is called Java Enterprise System, its desktop products Java Desktop System, and so on. “This will turn us into the Dell of the software industry,” says Mr Schwartz, by which he means a low-cost disrupter of the status quo. It is another precarious analogy, given that Sun still has to demonstrate that it can hold its own against Dell in hardware.

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Economist.com BUSINESS
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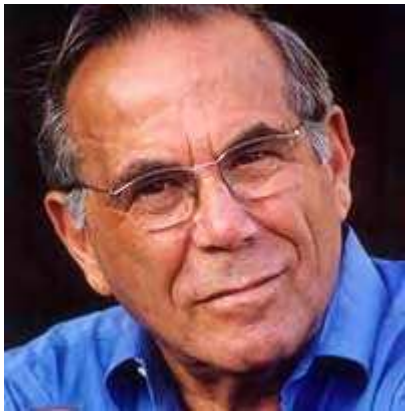
Face value

Peace through industrial parks

Sep 18th 2003
From The Economist print edition

Israeli entrepreneur Stef Wertheimer wants to convert the Middle East to capitalism



EVEN an optimist would have to concede that this is an awkward moment to arrange business deals in the Middle East. Political antagonism is nastier than ever, the local economies are worse, and the rest of the world is as polarised about the region as it has been in decades. Yet on September 17th, Stef Wertheimer, a 77-year-old Israeli entrepreneur, arrived in Washington, DC seeking money and support to build industrial parks in the Arab world, and he had a full schedule of congressmen willing to listen, including the House majority leader, Tom DeLay.

If they are open minded, it is due at least as much to a despair about past efforts to animate Arab economies as it is with optimism about Mr Wertheimer's plan. It is hard to find any Arab country with an economic model capable of sustaining long-term growth. Those countries that are rich have oil and little else, and oil will not last forever; the countries without oil suffer from widespread deprivation. True, Dubai is turning itself into a tourism and banking hub, and one or two other Gulf states have other niche ambitions, but they are too small to transform the region. The only nation in the Middle East that has a sophisticated, dynamic economy is Israel—though much governmental meddling there means that even Israel is not exactly a model of free-wheeling capitalism. Still, despite decades of war and terrorism, and lacking natural resources, it has managed to develop world-class companies and a strong middle class. Yet its economic model has not been imitated elsewhere in the Middle East.

Mr Wertheimer believes that this need not be so. He hopes to get America to help finance 100 private-sector industrial parks running around the eastern Mediterranean from Turkey to the Egyptian border. (Given America's struggle to finance the rebuilding of Iraq and Afghanistan, this is surely a long shot.) These, he believes, would foster export-oriented entrepreneurship and, ultimately, a change in world view. For a blueprint, Mr Wertheimer points to what he has already accomplished in Israel: four industrial parks with 162 companies, mostly start-ups, using Arab and Jewish workers. Collectively, they produce $600m annually in products, largely for export.

Mr Wertheimer is also part-owner of a park under construction in Gebze, near Istanbul, the first of two he hopes to build in Turkey. More strikingly, he has just signed an unprecedented deal that seemed to have fallen by the wayside during the Iraq war: within a year, Mr Wertheimer and a partner expect to have an industrial park under way near the airport in Aqaba, Jordan. Mr Wertheimer says that there are agreements in place for the park to produce components for DaimlerChrysler, Harmon International (audio components), and two machine-tool firms: South Korea's Taguetak and Germany's Gildemeister. Having already secured backing for this park, he wants to build, with local partners, four more in Jordan over the next five years—with the cost financed by an international consortium of governments he hopes that America will help assemble and by the private sector. Total employment in the parks, he estimates, could ultimately reach 12,500 and revenues could exceed $1 billion.

Mr Wertheimer's own experience with these parks dates back to 1982. In northern Israel, in an area inhabited mainly by goats, he built a complex of offices and factories to which he added basic utilities, transportation, schools and a central eating facility: what he calls a “capitalist *kibbutz*”. Access is provided to bankers, lawyers and people with business experience who can help other start-ups with taxes, regulations, finance and marketing—big challenges for entrepreneurs, especially in a tough business environment. Tenants must bring—and they are screened carefully—a viable product and likely customers. Rents are subsidised at first, then rise to market rates over five years with big winners encouraged to leave. “They get a party when they come, and a party when they go,” says Mr Wertheimer.

The promised land

Talks about building similar parks in Arab areas began over a decade ago. An earlier attempt in Jordan died along with King Hussein in 1999. It remains, however, an attractive location. Jordan has a peace treaty with Israel and fairly good relations. Its population is relatively well educated. It has few natural resources. Average income is $3,870 annually, less than one-fifth of Israel's. Jordan has arranged several deals with foreign firms in recent years, mostly thanks to a favourable trade arrangement with America for clothing and textiles. Mr Wertheimer says his parks will emphasise other lines of business. In 1999, Mr Wertheimer also reached an agreement with the Palestinian Authority to open an industrial park spanning the Gaza border, with a coffee shop in the centre. Construction was suspended when the *intifada* began but will, he insists, resume when the violence stops. He is clearly a man whose glass is always half full.

On top of public money, Mr Wertheimer expects the private sector to provide finance, machinery and above all, orders. If successful, these ventures will, he believes, take on a life of their own. A doubling of incomes in the region where they are located is possible within ten years, he reckons.

Hype? Perhaps. But Mr Wertheimer has spent a career triumphing against the odds. Fleeing Nazi Germany in 1937, he learned his trade as an apprentice to a refugee who developed an early camera for Zeiss, an optical company. He started a cutting-tool firm with a borrowed lathe and a loan from a local butcher. Now his firm, ISCAR, exports cutting tools worth $1 billion a year. It has 4,500 employees. Another 1,500 workers make turbine blades in a joint-venture with Pratt & Whitney and Rolls Royce, a result of an effort to circumvent a French boycott of replacement parts for Mirage jets during the 1967 war. “From adversity comes opportunity,” says Mr Wertheimer. If only for the beleaguered region's sake, pray that this proves true again.

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The New York Stock Exchange

The bell tolls for Grasso

Sep 18th 2003 | NEW YORK
From The Economist print edition

Richard Grasso's forced departure may set in train a thorough overhaul of the New York Stock Exchange

Get article background

AP

THE exchange's president had been caught raiding the widows' and orphans' fund. The chairman of the Securities and Exchange Commission (SEC) was sounding threatening. So it was that in 1938 the New York Stock Exchange (NYSE) placed its fate in the hands of William McChesney Martin, a 31-year-old security analyst nicknamed “Mr Chocolate” because hot cocoa, not the whisky favoured by others on Wall Street, was his beverage of choice.

Similarly, in the early 1960s, the crew who ran the American Stock Exchange were pushed out after an investigation prompted by the SEC. The lead investigator soon became the exchange's head. And in 1996 it was the turn of the technology-oriented NASDAQ stockmarket. Under pressure from the SEC's then chairman, Arthur Levitt, the market hired an ex-senator with a reputation for probity and sacked all its senior staff for breaking trading rules.

Every once in a while, in other words, some scandal engulfs one or other of America's stock exchanges. Repairs are carried out, men of good character are put in charge, and the system lurches forward again. There is no suggestion that Richard Grasso, who resigned as chairman and chief executive of the NYSE on September 17th, has broken any law or written rule. His crime was to be paid too much at once: $188m, of which he had refused $48m.

The sum caused uproar, both outside and, increasingly, inside the exchange. His reputation swiftly declined, from that of the steward of a public trust to that of the manager of a casino who had profited from stoking the enthusiasm of suckers. The reputation of the exchange sank along with that of the chairman. Alarmed, the NYSE's board called a snap meeting, at which Mr Grasso quit: how much money he will take with him remains unclear. To restore the exchange's reputation, an extensive repair job will be needed. The only question is the form it will take.

The Grasso effect

The recent storm notwithstanding, under Mr Grasso the exchange did remarkably well. Although other stock exchanges have lost business to electronic rivals (and have embraced electronic trading themselves), the NYSE still carries out most of the trading in the shares listed on it, despite retaining an open-outcry system. The exchange's trading costs have continued to be among the lowest in the world, according to Elkins/McSherry, a research firm. A result is that even as other open-outcry exchanges have disappeared, America's obsessively cost-conscious institutional investors continue to trade through the NYSE.

However, as Elkins/McSherry's data also shows, the NYSE's margin of superiority over other exchanges has diminished. This implies that Mr Grasso pushed trading costs only as far down as was needed to keep competitors (or regulators) at bay. If they were even lower—if it were easier, say, for electronic rivals to compete—investors would have done better, though the NYSE might have done worse.

Traditionally, the head of the NYSE has preached the virtues of investing in America. Mr Grasso raised this ceremonial role to a fine art, building the NYSE's image (and polishing his own) by ringing the opening bell regularly for television cameras and by playing up the drama of initial public offerings. This brought in new listings, on which the exchange thrived. But having read about Mr Grasso's compensation, many investors who have lost pots of cash in the past three years may think that the real beneficiary of their dollars was the grinning bell-ringer himself. The day before Mr Grasso left, the large civic pension funds in California and New York had demanded his resignation.

To convince investors that it is more than a hucksters' club, the exchange will have to do more than rid itself of one man. The payment to Mr Grasso has thrown up more questions about the way the place is run. The salaries of other top employees, such as its two co-presidents, Robert Britz and Catherine Kinney, have yet to be revealed. They are thought to be paid between $4m and $5m annually. Nor has the NYSE said how much it has paid board members, notably those who approved Mr Grasso's remuneration.

The affair has also cast a harsh light on the aesthetics—or ethics—of Wall Street pay. Floor brokers who helped reopen the NYSE in the panicky days and hours after September 11th 2001 were appalled that Mr Grasso received a $5m bonus for his performance. Many—throughout New York, not just at the exchange—worked harder and suffered more without thought of reward. More generally, Mr Grasso's package was based on the amounts paid to the heads of investment banks, which were among his paymasters. Reports that these people knew nothing of the pay deal made them look at best other-worldly, at worst negligent.

Should have seen it coming

With hindsight, many say that the problems with Mr Grasso's tenure have been unfolding for years. The ringing of the opening bell, the celebration of public offerings: all this now looks like a cynical triumph of style over substance. At the same time, the NYSE was ducking important questions. One of them was the cost of trading. Another was whether the exchange should ditch its mutual status and go public: in 1999 Mr Grasso pushed for a flotation, only for it to come undone. Last year, he did join the campaign by Eliot Spitzer, New York state's attorney-general, against Wall Street firms. But he did so only belatedly, and did nothing to dispel the widespread thought that the exchange, as a primary regulator, had let bad practices fester in the first place.

The exchange's board will hope that by getting rid of Mr Grasso and promising not to pay anyone such a silly amount again, it will stave off thorough reform. Yet the SEC still wants to get to the bottom of how Mr Grasso's pay was decided, and to dig deeper still. Even before the pay package became public, it was looking into the governance of the NYSE. The furore has brought many possibilities into play: the NYSE could be stripped of its regulatory powers; the composition of its board and various subcommittees could be altered, perhaps by winnowing out some Wall Street bosses. Some are reviving the idea of a public offering.

After past scandals, the upshot was not a thorough upheaval of regulation, but an internal spring-clean led by a strong figure. Already, names are being mentioned: one is Mr Levitt's; another is that of William McDonough, former head of the Federal Reserve Bank of New York, now overseer of America's accountants. It was in no one's interest, least of all the NYSE's, to prolong the Grasso affair. Although Mr Grasso has gone, the NYSE and the SEC still have a lot of work to do—and quickly, if confidence in the exchange and America's financial markets is to be rebuilt. If there is ever any consensus on Wall Street, it is that speed matters.

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About sponsorship

Derivatives exchanges

Eurex comes to town

Sep 18th 2003 | CHICAGO
From The Economist print edition

The German-Swiss exchange tries its luck in America

AP

The Europeans are coming

THE Europeans have thrown down the gauntlet. On September 16th Eurex, a German-Swiss derivatives exchange, unveiled detailed plans to set up a new, all-electronic market in Chicago early next year. Eurex US will be the first foreign exchange on American soil. Never have America's two largest futures exchanges, the Chicago Mercantile Exchange (CME) and the Chicago Board of Trade (CBOT), been challenged so directly.

Can Eurex US succeed? First, it needs regulatory approval from the Commodity Futures Trading Commission. It hopes to have this within 60 days. Then it will have to lure clients away from the Chicagoans and generate the liquidity that is the life-blood of a successful exchange.

Upstarts can thrive, as the International Securities Exchange has proved. America's first entirely electronic options market, launched three years ago, is now the world's largest equity-options exchange. Yet it had the advantage of being the first of its type, says Matthew Andresen of Sanford C. Bernstein in New York; Eurex does not, and is a foreign entity to boot.

But Eurex is confident. It is the world's largest derivatives exchange. It is already fully electronic, while its Chicago competitors still use a hybrid of electronic and floor trading. It also has $1 billion to spend, some of it probably on a smaller, local player in the next few months. Its initial products—futures and options on two-, five- and ten-year Treasury notes, and 30-year Treasury bonds, among others—will put it head-to-head with the CBOT, which dominates those markets. Eurex promises lower costs than the CBOT's and no membership fees, unlike its mutually owned competitor. It will also offer traders shares, and claims that its electronic market will be more “democratic” than those in Chicago. “You don't have to be six feet tall and weigh 200 pounds to elbow your way to the top of the pit,” says Michael McErlean, a Eurex executive.

But the Chicago exchanges have not been idle since January, when Eurex first announced its intention to challenge them, spurred by the CBOT's decision not to renew Eurex's contract to supply trading technology but to switch to its European competitor, Euronext.liffe. The CBOT and the CME, archrivals for many a year, struck a deal under which CBOT trades will be cleared through the CME, in order to lower costs. Eurex responded by allying with the Clearing Corporation, the CBOT's old clearing house.

Too much is at stake for the Chicagoans to be complacent. The CBOT, housed in an imposing Art Deco building at the foot of LaSalle Street, has been trading grain futures since 1848. It expanded into financial products in modern times. The CME has been around for 105 years. Many thousands of jobs are linked to the two (and the smaller Chicago Board Options Exchange), and traders' colourful jackets are a fixture in the financial district.

The Chicago exchanges are modernising. Terry Duffy, the CME chairman, says that over half of his 1,200 employees are dedicated to information technology and that 44% of the exchange's volume is electronic. Yet he is defensive about the CME's continuing use of pit trading. “We'll let the market decide,” he says, adding that the floor accounts for only 12% of the exchange's costs.

At the CBOT, where grain traders still wield a lot of power, change has been steered by Bernard Dan, its newish boss. Today 86% of its financial futures contracts (excluding agricultural products) are traded electronically. Mr Dan claims that the CBOT switched to Euronext.liffe's system because it is better than Eurex's. He thinks that the Europeans are too confident, using “spin” to oversimplify what it takes to succeed in the American market.

Even so, the Chicago exchanges are worried enough to be taking their case to Washington. In June, Mr Duffy and Charles Carey, chairman of the CBOT, told Congress they had serious concerns about foreigners owning exchanges in America. Rudi Ferscha, Eurex's boss and godfather of Eurex US, plays down the politics. “It's not such a political place when you look at the customers,” he says, predicting that clients will support the Eurex model out of self-interest. He seems to be calculating that their political clout, and that of the big financial firms that are shareholders in the Clearing Corporation, can counter the exchanges' weight in Washington.

Should Eurex US work, jobs at the Chicago exchanges are likely to suffer. Mr McErlean denies there is any threat to Chicago's prominence as a trading centre, but admits jobs may shift. “It'll be like squeezing a balloon,” he said. “Opportunities will disappear in some places, but they'll reappear somewhere else.” But if 500 traders in a pit are replaced by 500 traders at remote computer screens, what does that do to the trading centre? Many in Chicago might ask whether the air will be squeezed out of the Windy City.

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Funds of hedge funds

An expensive touch of glamour

Sep 18th 2003
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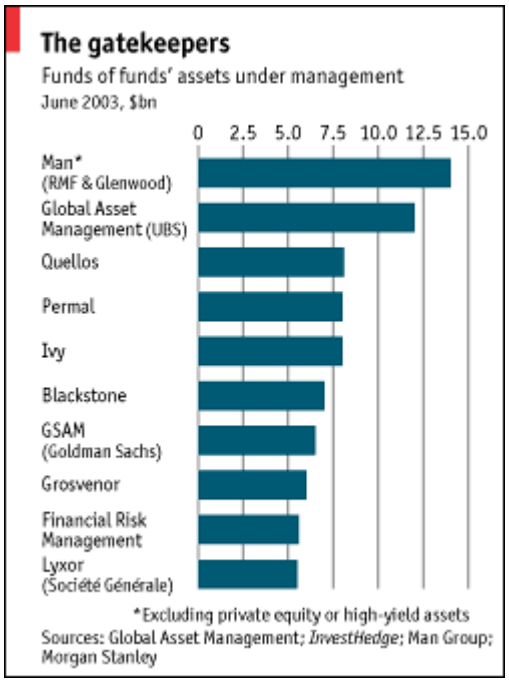
Cash is pouring into funds of hedge funds, but are investors in them getting their money's worth?



MAD, bad and dangerous, hedge funds once offered cocktails of stratospheric rewards and giddying risks to investors rich enough to spare a million dollars or more. The industry has changed, although its rakish image remains. Since the bear market set in, hedge funds have produced solid rather than spectacular returns. And they are no longer the preserve of the very wealthy. Mainly through outfits known as funds of funds, institutional investors and less rich (if, in the main, still pretty well-off) individuals are being offered a taste of the hedge funds' glamour.

As their name suggests, funds of funds spread their clients' money among several hedge funds. The idea is that investors will enjoy the fat returns that hedge funds can bring, but that diversification will diminish the risk. Not surprisingly, an increasing number of investors are attracted by this notion. However, the rewards have so far been disappointing.

To choose their hedge funds, managers of funds of funds go to remarkable lengths. They not only tour the world assessing funds, but also might hire private investigators and delve into the private lives of hedge-fund managers (might that impending divorce be a distraction?). After several months, they select a portfolio, usually of between five and 25 hedge funds.

Funds of funds now account for about 30% of the $650 billion invested in hedge funds. According to Hedge Fund Research, a research company, the value of assets in funds of hedge funds doubled last year. Inflows rose five-fold, to $103 billion. The number of funds of funds increased from 550 in 2001 to more than 780. Most offer tailor-made funds for some clients—such as a Swiss private bank—as well as off-the-peg funds for less exalted investors.

European institutional investors already include a Swedish state pension fund and PGGM, a Dutch pension fund with €45 billion ($50 billion) under management. In Britain, the pension funds of Shropshire county council, Sainsbury's, a supermarket chain, and Pearson, part-owner of *The Economist*, are thinking about joining the trend. In a recent survey of 341 European institutional investors by J.P. Morgan Fleming, 56% said that they were planning to invest more in hedge funds. Of these, nearly two-thirds would choose the funds-of-funds route.

In America, hedge-fund investment, which among institutions used to be largely confined to endowment funds, is spreading to pension funds and insurers. The California Public Employees Retirement System, America's largest pension fund, is thinking about tripling the $1 billion pledged for investment in hedge funds and funds of funds.

So alluring are funds of funds that investors are willing to pay a double whack of fees to place their money. They pay a management fee of between 1% and 3.5%, plus a performance fee (except at some funds where management fees are higher). On top of this, the underlying hedge funds charge management fees of 2% and one-fifth, or more, of profits. Investors also have to accept that they will never really hit the jackpot. One of the hedge-fund managers in their portfolio might turn out to be the new George Soros; but that means that the rest of the money is with people without the same golden

touch.

So what do investors get for their fees? They hire funds-of-funds managers' inside knowledge: these specialists know their way through the maze of hedge-fund strategies, from long-short equity funds, which buy undervalued equities and short-sell those they deem too dear, to “macro” funds, which bet on any security, anywhere. Investors also buy access that was once exclusive: people with as little as $1,000 to spare can invest. Funds of funds are more open with their clients, and more liquid, than hedge funds. At GAM, one of the biggest, investors can redeem their money within five days. Hedge funds generally ask investors to lock in their money for three months; some insist on a year.

All of this means that investors have to sacrifice the thought of truly juicy returns, although such returns are precisely why many are drawn to funds of funds in the first place. “The question is how much of absolute returns are you willing to give up for a fund of funds,” says David Smith, chief investment director at GAM. In the first eight months of this year, says Hedge Fund Research, hedge funds returned 12.2% on average. Funds of funds made 6.5%. Last year was the only one of the past ten in which funds of funds did not trail the company's hedge-fund index. After taking such care to seek out the world's finest hedge funds, funds of funds might have been expected to do better than this.

Of course, some funds of hedge funds have done much better than the average. “The good ones definitely earn their fees,” says Chris Woods, chief investment officer for hedge-fund strategies at State Street Global Advisors. But most of them struggle to justify the double layer of charges. With this performance, will investors keep pouring money into funds of funds?

In part, the weakness of stockmarkets in the past three years has fed investors' interest in hedge funds. If stockmarkets continue to rally, says Mr Smith, the fashion for hedge funds will wane. So, by extension, should the attraction of their gatekeepers, the funds of funds. And that might change the hedge-fund industry again. With their staid institutional clients, funds of funds have helped to tame hedge-fund managers. A business that was exclusive and secretive once more might see the return of its old, high-octane ways.

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Crédit Lyonnais and Executive Life

New evidence

Sep 18th 2003
From The Economist print edition

What the chairman saw

AFP

Also known as J.P.

IN DECEMBER 1998 a whistle-blower alerted the American authorities to the possibility that Crédit Lyonnais, then a state-owned bank, might have acted illegally when it bought Executive Life, a Californian insurance company that went bust in 1991. Recently the bank admitted its culpability and agreed to pay a $100m fine to settle criminal charges rather than face trial. Final details of that settlement, which could cost the French taxpayer a further $450m, are still being negotiated. Jean Peyrelevade, chairman of the bank since November 1993, announced on September 9th that he will resign once the settlement is complete.

In January 2001 *The Economist* revealed that the bank had always known that the complex, but highly profitable, scheme it created in order to buy and then sell Executive Life was illegal. The scheme was of great financial benefit to one of the bank's biggest clients, François Pinault (one of France's richest tycoons, who now, among other things, controls Au Printemps, a retailer, and the Christie's auction house). We showed how the deal, which took until 1995 to complete, had the close attention of senior managers. In particular, a 17-page fax which included details of the scheme was sent to the office of Mr Peyrelevade on December 10th 1993. We argued that the fax showed that Mr Peyrelevade should have known about the affair.

Mr Peyrelevade has always maintained that he knew nothing of the fax or its contents until after December 1998 when it was discovered during an internal inquiry. He sued *The Economist* for libel for our article in January 2001, but lost. (Strangely, he won €3,000 damages, however, for a subsequent article we published about Executive Life making the same allegation.) During the libel trial, and elsewhere, Mr Peyrelevade stated that Dominique Bazy, his second-in-command, was the intended recipient of the fax. He also said that he always put his initials on documents he had read. Because the fax was not initialled, he argued, he could not have seen it.

The Economist has now obtained a new document. It is a further copy of the fax of December 1993. Unlike previous copies, this one contains Mr Peyrelevade's initials, indicating that he reviewed the document. Margin notes on other pages correspond precisely to questions that other documents show he raised about the complex scheme at a meeting of the bank's Executive Committee on December 13th 1993.

Having checked the document's authenticity, we asked Mr Peyrelevade to explain how he reconciles it with the position he stated during his lawsuits against us. His office says that he cannot respond because of “confidentiality obligations” to the American authorities.

The clear implication of the document is that Mr Peyrelevade knew about the wrongdoings in 1993, but permitted the scheme to proceed. When the illegal venture was revealed five years later, he first blamed colleagues and then stuck resolutely to his claims of ignorance, to the point of suing us for libel. Mr Peyrelevade, it should be noted, was brought in as chairman in 1993 supposedly in order to clean up the bank's previous wrong-doings. This did not happen in the case of the Executive Life affair.

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Insurance in China

Synchronised dreams

Sep 18th 2003
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Foreign insurers eye up a fast-expanding market

NO ONE in business needs reminding of the scale of the opportunities that lie in China's fast-growing economy. Foreign life insurers are jostling as hard as anyone else, and it is not hard to see why. According to the China Insurance Regulatory Commission (CIRC), total insurance premiums in the country were 212.6 billion yuan ($25.7 billion) in the first half of this year, 32% more than in the same period in 2002. Life-insurance premiums, at 165.3 billion yuan, were 39% up.

This rapid growth reflects a shift in the financial circumstances and needs of many Chinese. The Chinese have long been big savers, but have tended to put their money in low-interest bank accounts or to keep it under the mattress. Now, increasing affluence and the gradual withdrawal of the state from social security are pushing more people to buy life insurance as an alternative means of saving.

However, the market is opening much less quickly than it is growing. As part of the terms of China's entry to the World Trade Organisation, foreign insurers will be able to acquire licences to operate nationally by 2005. For now, though, the CIRC grants licences one branch at a time—slowly, and in only a few provinces.

Opportunities for profit are also limited by restrictions on how insurers, both domestic and foreign, can invest premiums. Although the rules were relaxed this year, insurers still can put at most 15% of their money into equity funds and 20% into corporate bonds, which must be rated at least AA. Most of the rest goes into low-yielding bank deposits or Chinese government bonds. Partly for this reason, only one of the 20 foreign life insurers recently licensed to do business in China—CITICPrudential, a Sino-British joint venture—is expected to make a profit by next year. AIG, an American giant, has been operating profitably in China for several years.

Furthermore, foreign insurers—other than AIG—are obliged to set up joint ventures with domestic partners whose main business is not insurance. This, plus barriers of culture and language, means that finding the right partner is the biggest hurdle for foreign companies, says Jonathan Bloomer, chief executive of Prudential, the British co-owner of CITICPrudential. Teaming up is useful—the Chinese partner can bring handy contacts, for example—but management styles can conflict.

Some insurers are also unhappy about China's capital and solvency requirements, which were tightened last month: companies must now put more capital aside every time they open a new branch. Others, however—such as Britain's Standard Life, which last year was authorised to operate in Tianjin province—think that the regulator is right to keep reserve requirements high, in order to protect consumers in this young market.

By and large, though, foreign insurers are optimistic. With such a large market just beginning to open up, who wouldn't be? In any case, some restrictions matter less in a newish market than they would in a mature one. In remote and rural provinces, licences may be hard to come by, but demand is so low that it is probably not worth setting up shop. Because China's capital markets are underdeveloped, limits on how insurers invest may be no more than prudent. High capital requirements may prompt foreign firms to choose their local partners with extra care. And in a strange, new place, this is a crucial choice. As the Chinese say, if you want to sleep in the same bed you have to be sure you're dreaming the same dreams.

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Latin American stockmarkets

Looks good on paper

Sep 18th 2003 | LONDON AND SÃO PAULO
From The Economist print edition

What's behind the rise in Latin American shares?

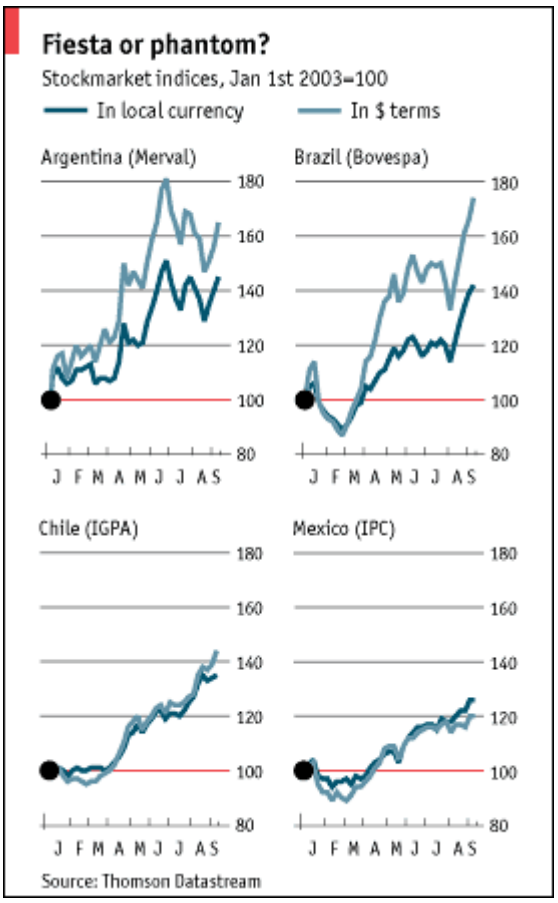
EMERGING economies' stockmarkets have had a jolly year. Latin America has shared in the fun, despite its past form. Investors have been burnt often since the mid-1990s. In 2001 Argentina defaulted on its foreign debt. The orthodox “Washington consensus” on economic policy has been called into question. And yet this year stockmarkets have soared (see chart). The Argentine and Brazilian indices have both risen by 70% in dollar terms, and Chile's by 40%. The returns from Mexico are less spectacular, thanks in part to a weakening peso, but nonetheless have still beaten America's S&P 500.

Nice returns, if you can get them. Often, you cannot. The price of Venezuelan equities, for example, has more than doubled since the turn of the year. But this is largely thanks to exchange controls that have kept capital in the country. Those controls mean that foreigners could scarcely have profited—had they wanted to: one fund manager says that no foreign client has expressed interest in seven or eight years.

Argentina, too, flatters to deceive. The market's climb is based partly on the country's recovery since the default. Yet the disaster rendered the shares of many of its companies worthless or untradable. Delistings have been so common that most of Argentina's representation in the oft-cited MSCI index of emerging stockmarkets is now based on the shares of only three companies, whose prices have soared from a low base. Paltry liquidity means that it is almost impossible to take advantage of the Merval index's flashy returns.

However, Latin America's equity surge is not simply a mirage. Chile's market is more open to foreign investors, although its free float is small. Share prices there have benefited from a rising copper price, which has made investors more optimistic about the economy as a whole. Its corporate governance is far better than in other South American countries. Lately, however, the stockmarket has cooled a bit.

The region's second-biggest market, Mexico, is also open to foreign investors. Its fortunes, like those of the national economy, are intertwined with the health of its giant northern neighbour. Movements in its main index match the twists and turns of American stockmarkets more closely than those of other Latin American countries. Thus any question marks over America's recovery might also worry investors in Mexico. In addition, factors peculiar to Mexico have limited its stockmarket's rise. There are fears over competition from China. And the presidency of Vincente Fox has not lived up to high expectations on reform or eliminating corruption.



The real star, however, has been Brazil. The roots of the boom are political. Investors have been pleasantly surprised by the policies of Luiz Inácio Lula da Silva, who became the country's president in January. Before taking office, he was regarded by some as a dangerous fellow who would default on Brazil's huge external debts. He also had some radical ideas about how to run the economy. However, Lula (as he is known) has been at pains not to frighten foreign investors.

So far, they have been reassured. Certainly the bond markets take him at his word—or are hungry enough for yield, in these low-interest days, to take a chance. The yield on 20-year Brazilian government bonds is now 6.6 percentage points more than that on American Treasuries. Last autumn, the spread was 24 points. Domestic interest rates have been cut too—most recently, this week—making it less likely that Brazilian companies will go bust. The cost of investment has also been reduced. This has pushed up share prices. Punters are expecting that domestic interest rates will fall further.

Believe it or not, prices might rise further still. Marcelo Mesquita, head of equity research at UBS in Rio de Janeiro, says that Brazilian shares are still cheap compared with those in other emerging markets. Their prices average about seven times this year's expected earnings, compared with a price-earnings ratio of about 11 for emerging markets as a whole.

There are pitfalls. Brazilian corporate governance is far from perfect. Mr Mesquita of UBS points out that almost all Brazilian companies exploit a law that lets them issue non-voting shares for up to two-thirds of their capital, allowing insiders to exercise control with only 17% of the capital. This leads to all sorts of mischief that shields companies from takeover bids, which might benefit minority shareholders. Brazil's market for so-called growth stocks, the *novomercado*, does not allow such non-voting shares and sets high standards for corporate governance. Unfortunately, only two companies are listed on it.

Even so, Brazil remains the chief attraction. Should Lula lose his appetite for further reform, then shares could slump. That would not be the first time Latin America had dashed foreigners' hopes.

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Economics focus

Working capital

Sep 18th 2003
From The Economist print edition

A manifesto to raise employment

AS DEVELOPED economies emerged from their last deep recession in the early 1990s, there was high anxiety about high unemployment. Thus in 1994 the OECD set out a programme of labour-market reforms through which its member governments might cut the jobless count. A decade on, rich economies are recovering from another slowdown and unemployment is on the rise once again. On September 17th, in its annual *Employment Outlook*, the OECD issued a new manifesto that reflects the anxieties of western governments about jobs. But the aim this time is not just to reduce unemployment but to raise employment.

Eh? What's the difference? Plenty, in fact. To be counted as unemployed, people usually have to be part of the labour force: they must be available to work and actively looking for a job. But there are many other people of working age—housewives, students, lone parents, disabled people and early retirees—who neither have work nor seek it. These are termed the “economically inactive”. Policies to cut unemployment aim to lower it as a share of the labour force. Policies to raise employment aim to raise the proportion of the whole working-age population with jobs, not just by getting the unemployed into work but also by mobilising the economically inactive.

One reason for setting the new goal is that OECD governments have had some success in bringing down unemployment during the past decade. Generally, jobless rates have fallen; in some countries, notably Ireland, spectacularly. Some of the gains have been lost during the recent global slowdown, but the setback has been less severe than in previous downturns. Much of the long-term improvement will therefore prove sustainable, argues the OECD.

However, the emphasis on raising the employment rate also reflects new concerns, especially in Europe. A particular worry in the early 1990s was that too many young people were unemployed—ie, looking for work but unable to find it. Now, governments are concerned that there are too few young people in the labour market overall. In the European Union, there are now four people of working age for every person aged 65 or over. By 2035, this ratio will have fallen almost to two-to-one. As it falls, the burden on workers of tax-financed pension schemes will rise and public budgets will come under ever greater stress. One remedy is to raise the employment rate and so increase the number of people contributing to public pension schemes.

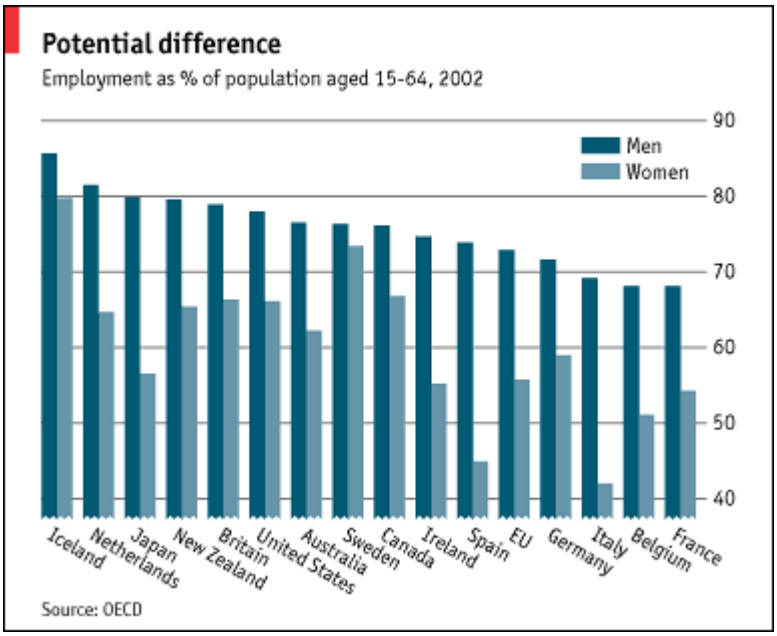
The rationale for cutting unemployment is straightforward. If people who want to work cannot find jobs, then potential labour resources are being wasted and taxpayers are having to support the involuntarily idle. The rationale for raising employment is less obvious. There are good reasons why students, for example, are not employed. If people choose not to work and can support themselves, what business is it of the state—however cash-strapped—to try to push them into work?

One answer is that inactivity costs taxpayers money, over and above what they must pay to support the unemployed. Besides unemployment payments, there is a wide range of other benefits, including support for early retirement, disability and lone parenthood. In the EU, there is now one person of working age receiving a benefit for every three people in employment. In America and Japan the figure is one in five. In many countries a majority of people who are neither employed nor in education get some form of income support.

Springing the trap

This benefit culture is not just a burden on the working taxpayer. It also generates incentives for people

not to work. In the early 1990s, the talk was of unemployment traps, where high, long-lasting benefits dull the spur to find work. Now the OECD highlights inactivity traps where people outside the labour force face little financial incentive to seek work.



The substantial variation in employment rates between broadly similar economies suggests that in some countries there is plenty of scope for getting more inactive people into work. In Iceland, for instance, 80% of working-age women are employed; in Italy, the figure is a mere 42% (see chart). The report estimates that a convergence in working patterns would raise the average employment rate (for women and men) in OECD countries from 65% to 77%. Based on what the economically inactive say about their willingness to work, the increase would be less, to 72%.

It is easier to identify the potential gain than to realise it. The OECD sets out three main policies. The first is to make work pay for the low-skilled. To encourage more of them into the labour market, more use could be made of top-up benefits for those on low wages. Reduced payroll taxes on low-paid jobs would enhance employers' demand for such labour. The second is to remove other barriers to joining the workforce such as the difficulties women find in juggling families and jobs; for example, through subsidising child-care services. The third is to restrict the flow of people on to out-of-work benefits and to encourage those already getting them to look for jobs.

The main question is whether governments will have the courage to implement the more unpopular reforms. By extending in-work benefits, they will offer people a carrot to join the labour force; but as long as people can draw welfare payments when out of work, there will be no accompanying stick. The OECD calls for the removal of incentives to early retirement, but this requires unpopular reforms, not just to pensions but also to other benefits that allow older people to quit the workplace.

Some increase in employment rates will occur anyway as a younger generation of working women replaces an older generation that largely stayed out of the labour force. But most countries will struggle to raise the employment rate without harsh reforms. The OECD's manifesto sets a daunting challenge.

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About sponsorship

Galileo and Jupiter

Magnifico!

Sep 18th 2003
From The Economist print edition

NASA

Galileo, a spacecraft that has been studying Jupiter, will self-destruct this week, after a glorious decade of exploration

Get article background

WHEN, on September 21st, *Galileo* plunges into Jupiter's atmosphere and burns up, it will be a cause for celebration rather than alarm. This is because the spacecraft is being destroyed deliberately, in order to eliminate the possibility that it might contaminate Europa, one of Jupiter's moons. Europa, according to *Galileo*'s instruments, has an environment that might, just, harbour life. So it would be unfortunate if, come the day when life-seeking craft land there, what they found were bugs brought all the way from Earth.

Admittedly, it is unlikely that any such bugs would have clung to life since *Galileo* was launched in October 1989, but it seems a good idea to avoid any risk of contamination. It would be a shame to spoil *Galileo*'s mission with such an ending. After a shaky start, the craft has been one of NASA's most successful enterprises, and an example of what America's space agency does best—pushing back the frontiers of understanding, both literally and metaphorically, rather than keeping underemployed astronauts in low Earth orbit, and occasionally killing them.

Look up to the skies, and see

Galileo was originally meant to be launched in 1982. But problems with the space shuttle, culminating in 1986 with the explosion of *Challenger*, pushed its launch date back. Then, when it did eventually get into space, its main antenna, which was supposed to transmit the scientific data collected by its instruments back to Earth, jammed when ground-controllers tried to open it. This should have spelled the end of the mission, because the only other means of communication, a rudimentary antenna used for basic communications, could transmit a mere 10 bits (about one letter of the alphabet, converted into binary code) a second.

But, in one of the most remarkable feats in the history of computer science, *Galileo*'s operators completely reprogrammed the craft's computers to take advantage of modern data-compression

methods. They also jury-rigged a system that used a cassette deck intended for other purposes to record data when *Galileo* was doing something interesting, such as flying past one of Jupiter's moons. The data were then transmitted to Earth during boring periods. This audacious effort restored *Galileo* to something close to perfect working order.

The cassette deck's original role was to record data sent to *Galileo* by a probe that separated from the craft when it was still 81m kilometres (50m miles) from Jupiter. This probe was fired into Jupiter. It survived for an hour as it streaked through the upper reaches of Jupiter's atmosphere. During that time it transmitted details of the composition of the air (less oxygen and sulphur, but more helium than expected) and the weather (less lightning than forecast, but higher winds).

Galileo's route to Jupiter also passed within 2,500km of an asteroid called Ida. When it did so, it discovered that Ida had a small moon. Although astronomers had long supposed that some asteroids have moons, *Galileo*'s was the first observation of one. The delay to the mission was also fortuitous because, although *Galileo* was still 240m kilometres away at the time, it saw the collision between comet Shoemaker-Levy 9 and Jupiter, in July 1994, from a better perspective than any Earth-based instruments.

Goodbye, everybody, I've got to go

Galileo's most remarkable discoveries, however, and the ones that dictated that it would eventually follow the probe's fiery fate, were made not about Jupiter itself, but (appropriately) about the four large Jovian moons discovered by Galileo Galilei, the 17th-century astronomer after whom the craft was named. Although these moons—Europa, Callisto, Ganymede and Io—are distant from the sun, they are heated by tidal “friction” caused by their gravitational interactions with each other and with Jupiter.

The *Voyager* probes, which flew by Jupiter in 1979, caught a fleeting glimpse of volcanoes on Io, the closest of the four to Jupiter. Building on this discovery, *Galileo* found that Io is by far the most volcanically active body in the solar system—about 100 times more active than Earth. It also found that Ganymede, the largest moon in the solar system, has a magnetic field. This result was unexpected, too.

The other two moons, though, yielded the jewels in *Galileo*'s crown of discoveries. Researchers had long suspected that Europa might have an ocean. Galileo confirmed that it does, though the liquid water is located beneath an icy crust. Indeed, Europa's ocean could be as much as 100km deep, which would mean that Europa has more water on it than Earth. Callisto, too, may have an ocean beneath its icy surface, though this is less certain. The ocean on Earth is thought to have been where life started, so these discoveries have led optimists to wonder whether the moons of Jupiter, rather than the deserts of Mars, may yield the first signs of extraterrestrial life.

It is to keep this hope alive that *Galileo* is being destroyed. It is running out of fuel for its thrusters, and once that has gone its path will be at the whim of the gravitational fields of Jupiter and its moons. The risk of an eventual collision with Europa, though small, is not zero. Eliminating that risk is probably the responsible thing to do. And it certainly looks responsible, a fact no doubt noticed by NASA's publicists.

Galileo's fate, though, raises another question. Fuel is often the limiting factor for planetary probes. The thrusters on such probes use chemical fuels, which have a lot of mass for the thrust they produce. A more efficient propulsion system would allow more thorough, and longer, explorations of the solar system. Unfortunately, the easiest way to make a more efficient engine, nuclear-electric propulsion, is controversial. It works by using electricity generated from a nuclear reaction to accelerate charged particles out of the back of the spacecraft. This provides a small but steady (and efficient) thrust.

Use of the “N” word tends to generate controversy, though the risks to people from an accident on launch would be low (and from an accident in space, zero). Nevertheless, NASA is working on a successor to *Galileo*, called JIMO (Jupiter Icy Moons Orbiter), that would take advantage of nuclear-electric propulsion.

If all goes well, JIMO will be launched in 2011. It will be able to orbit Europa, Callisto and Ganymede individually, hopping from one to another. As Bertolt Brecht said in his play about the real-life Galileo: “The world of knowledge takes a crazy turn/When teachers themselves are taught to learn.”

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Astronomy

Planetophagy?

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A mysterious burst of light was a star eating its solar system

Burp!

IN JANUARY 2002, Nicholas Brown, an amateur astronomer in Australia, noticed something had changed in the sky. A star called V838 Monocerotis was 10,000 times brighter than normal. This, in itself, was not that strange. It is what happens when a star “goes nova” in a dramatic explosion. However, as observatories around the world turned their telescopes (including the Hubble Space Telescope, which took the picture shown) towards V838, astronomers were baffled. This was because the star got brighter and then dimmed in a fashion that had not been seen before. It was also distinctly off-colour.

In a forthcoming paper in the *Monthly Notices of the Royal Astronomical Society*, two other researchers in Australia contend that they have solved the mystery. Alon Retter and Ariel Marom, professional astronomers at Sydney University, believe that the star, a so-called red giant, swallowed three of its planets.

They have several reasons for saying this. The first is that as V838 got brighter, it did not get much hotter. The only other way it could have got brighter is by getting bigger. One way that it might have grown is by swallowing its planets.

The second reason to believe that this is, in fact, what happened is that V838's brightening showed three distinct peaks. These, the researchers contend, correspond to its consumption of each of the planets. Finally, the star's spectrum, which contains information about its composition, showed a lot of lithium. Stars normally consume lithium voraciously in the nuclear reactions that power them, so V838 must have had a recent injection of the element from somewhere. An evaporating planet is the most likely source.

If Dr Retter and Dr Marom are right, it will have been the first time a star has been seen consuming planets, although theorists have long suspected such events occur. Fortunately, the sun will not do the same for 5 billion years. As for all the other stars out there, *bon appetit*—it sure makes for a pretty picture.

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Archaeology

In the forest, something stirred

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People built towns in rainforests, too

ROUSSEAU'S noble savage casts a long shadow. The idea that “primitive” people lived in harmony with nature is a powerful myth, believed by many even today. But myth it is. Even in that icon of greenness, the Amazonian rainforest, it seems that people had the urge to civilisation, with all the destructiveness of pristine nature that this involves.

Michael Heckenberger, of the University of Florida, Gainsville, and his colleagues have been working in the Upper Xingu region of Mato Grosso state, in Brazil. At the moment, it is sparsely populated. However, it is clear from the team's study, which has just been published in *Science*, that a few centuries ago the area was densely settled. Dr Heckenberger has identified the remains of 19 settlements, organised into two clusters. Each cluster had a population of many thousands.

The settlements were between three and five kilometres (two to three miles) apart, and were linked by a network of broad, straight roads. There were also dams, bridges and canals. And the land between was used to produce food.

There is one difference, though, between the way that the citizens of these towns managed the forests for agriculture, and the way that modern farmers approach them. The modern tendency is to clear-cut an area (albeit that more ecologically minded farmers will leave blocks of unfelled forest on their land). The farmers in the ancient settlements of the Upper Xingu, by contrast, created gardens, orchards and parklands for growing crops within the forest, rather than knocking most of it down. But lest the ghost of Rousseau raise its head, that was probably due as much to a lack of metal tools for the efficient felling of trees as it was to a finely honed sense of stewardship of the land.

The forest has now grown back. The settlements identified by Dr Heckenberger and his colleagues were established, according to radiocarbon dating, between 1250 and 1400. By 1600 they were gone—probably victims, in one way or another, of the arrival of Portuguese colonists in Brazil. But, as a final blow against the Rousseauesque view of the world, the pattern of vegetation in the once-settled areas is still very different from that of virgin forest. Once the hand of man turns the soil in a rainforest, whether that hand be western or Amerindian, it takes a long time for the forest to recover completely.

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Animal behaviour

Fair and square

Sep 18th 2003
From The Economist print edition

Some monkeys seem to have a highly developed sense of fairness

EVERYBODY loves a fat pay rise. Yet pleasure at your own can vanish if you learn that a colleague has been given a bigger one. Indeed, if he has a reputation for slacking, you might even be outraged. Such behaviour is regarded as “all too human”, with the underlying assumption that other animals would not be capable of this finely developed sense of grievance. But a study by Sarah Brosnan and Frans de Waal of Emory University in Atlanta, Georgia, which has just been published in *Nature*, suggests that it is all too monkey, as well.

The researchers studied the behaviour of female brown capuchin monkeys, which have all the necessary ingredients to capture the public imagination. They look cute. They are good-natured, co-operative creatures, and they share their food readily. Above all, like their finicky female human counterparts, they tend to pay much closer attention to the value of “goods and services” than males (although why this is so remains a mystery).

Such characteristics make them perfect candidates for Dr Brosnan's and Dr de Waal's study. The researchers spent two years teaching their monkeys to exchange tokens for food. Normally, the monkeys were happy enough to swap pieces of rock for slices of cucumber. However, when two monkeys were placed in separate but adjoining chambers, so that each could observe what the other was getting in return for its rock, their behaviour became markedly different.

In the world of capuchins, grapes are luxury goods (and much preferable to cucumbers). So when one monkey was handed a grape in exchange for her token, the second was reluctant to hand hers over for a mere piece of cucumber. And if one received a grape without having to provide her token in exchange at all, the other either tossed her own token at the researcher or out of the chamber, or refused to accept the slice of cucumber. Indeed, the mere presence of a grape in the other chamber (in the absence of an actual monkey able to eat it) was enough to induce sullen behaviour in a female capuchin.

Dr Brosnan and Dr de Waal report that such behaviour is unusual in their trained monkeys. During two years of bartering prior to these experiments, failure to exchange tokens for food occurred in fewer than 5% of trials. And what made the behaviour even more extraordinary was that these monkeys forfeited food that they could see—and which they would have readily accepted in almost any other set of circumstances.

The researchers suggest that capuchin monkeys, like humans, are guided by social emotions. In the wild, they are a co-operative, group-living species. Such co-operation is likely to be stable only when each animal feels it is not being cheated. Feelings of righteous indignation, it seems, are not the preserve of people alone. Refusing a lesser reward completely makes these feelings abundantly clear to other members of the group. However, whether such a sense of fairness evolved independently in capuchins and humans, or whether it stems from the common ancestor that the species had 35m years ago, is, as yet, an unanswered question.

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Conservation

Who guards the guardians?

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An audit of conservationists

HERE'S a novel idea: auditing NGOs. Non-governmental organisations, as many charities are pompously described these days, often escape the sort of scrutiny that they, themselves, like to apply to governments and companies. But NGOs are human organisations, too, with all the scope for laziness, inefficiency and even corruption that any group of people risks falling into if it lacks either self-discipline or external scrutiny. To apply such scrutiny to one small corner of the NGO world, an organisation called Elephant Family (admittedly itself a species of NGO) decided to audit the efforts of NGOs to preserve the Asian elephant.

Say the word “elephant” to many people, and the image that comes to mind will probably be of a huge beast lumbering across an African savanna. Say it to an Asian, and a beast of burden ridden by a *mahout* is an equally likely picture. The plights of wild African elephants, gunned down for their ivory, and domesticated Asian elephants, made redundant by powered machinery, are well known. But Asia has its wild elephants, too. Unlike their African cousins, though, they mostly hide in forests. Few people seem concerned with their fate. Although 21 NGOs in ten countries claim to be in the business of preserving Asian elephants, a mere $4m a year is actually spent on the job.

Still, $4m is a sum worth auditing, and Elephant Family commissioned Paul Jepson and Susan Canney, two researchers based in Oxford, to do so. Their results make interesting reading.

No one really likes being audited, and NGOs are no exception. However, a pattern emerged: the best projects were run by local organisations rather than international ones.

Not that surprising, really, but worth reminding armchair conservationists in the rich world. Local enthusiasts are highly motivated, whereas, as the report itself puts it: “Competition for funds and publicity among the larger NGOs results in a divided movement that is not making the best use of its assets. It also results in the diversion of funds from conservation to institutional survival, self-interest and a lack of transparency.” Ouch.

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America's economy

Mr Stiglitz goes to Washington

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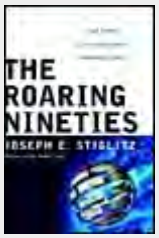
Getty Images

When economics meets politics, guess which one wins

HE MADE his popular reputation arguing that everything had gone wrong with the IMF, the World Bank and globalisation in general, and that it could all have been so much better if only people had taken his advice when he was chief economist of the World Bank in 1997-2000. Indeed, Joe Stiglitz, a Nobel prize winner in economics in 2001, has become a hero to anti-globalisation activists as a result of his “Globalisation and its Discontents” (2002). For that reason, this reviewer opened his new book with some trepidation: would Mr Stiglitz now say that the American economy would have performed so much better if only Bill Clinton and others had taken his advice when he was on the White House's Council of Economic Advisers in 1993-97? Well, yes he does, in fact. But he also says a great deal more.

The Roaring Nineties: A New History of the World's Most Prosperous Decade
By Joseph E. Stiglitz



W. W. Norton; 256 pages; $25.95. Penguin/Allen Lane; £18.99

Buy it at
Amazon.com
Amazon.co.uk

“The Roaring Nineties” advertises itself as “a new history of the world's most prosperous decade”. It isn't, really. Only people who spent the decade on Mars will need to learn that the United States had an economic boom during the 1990s which ended in a stockmarket crash in 2000-03, and that the world economy also entered the 21st century with a slowdown. Few, especially readers of this bubble-obsessed newspaper, will be surprised to find that the Federal Reserve helped inadvertently to inflate the financial boom by keeping interest rates low and talking a lot about a productivity revolution, and that it deserves criticism for doing so. Nor will they be shocked to discover that America had some accounting and fraud scandals that might have been prevented had regulators and corporate directors done a better job.

The real interest lies elsewhere, in the parts of Mr Stiglitz's book that are in effect a memoir of what life was like as an economic adviser, and indeed a considerable intellectual, in the bruising and often brutal world of Washington politics and policymaking. It is a sobering tale, told with a ring of honesty. The memoir is interleaved with a sort of analytical chronology of the period, but time after time a controversial policy issue comes up and we read about the role that the Council of Economic Advisers

played in determining what to do. Usually, it makes a sensible analysis of the problem, and proposes what should be done: over a capital gains tax cut, for example, or stock-option accounting, or pension reform, or telecoms deregulation. Then, political reality takes hold and the economists are ignored.

Despite bumping so often into powerful interest groups and crude politics, Mr Stiglitz retains an enormous faith in government. Nor does he blame Mr Clinton for the fact that so many things, in his view, went wrong during the 1990s, for he thinks Mr Clinton meant well. He does direct a lot of ire at the Treasury, which chiefly means at Mr Clinton's three Treasury secretaries, Lloyd Bentsen, Robert Rubin and Larry Summers, of whom the last two are to be blamed for much of what has gone wrong in developing countries, for they personified the policy ideas known as the “Washington consensus”.

Even so, in Mr Stiglitz's personal philosophy, which he calls “democratic idealism”, government has a big part to play. This is hard to square with his account of government so often doing the wrong thing for the wrong reasons, though markets do go wrong too. And, perhaps inevitably, his philosophy provides little operational guidance, beyond always seeking the “right” balance between government and markets, whatever that means, and “global social justice” (ditto).

Still, Mr Stiglitz means well. Yet, in the end, he too is a political creature. Mostly, he writes in a tone more of sorrow than of anger, as he narrates the failings of the eight Clinton years and the biggest financial bubble in history. Yet at the end the tone changes abruptly to one of contempt and anger as he describes the so-far short presidency of George Bush, during which, despite actually presiding over a remarkably mild recession given the bubble that preceded it, Mr Bush stands accused of rending the fabric of America asunder. Now, there is much to criticise in the Bush administration's policies. Yet to have achieved as much damage as Mr Stiglitz alleges would require genius. A true democratic idealist would have shared out his condemnation more equitably.

The Roaring Nineties: A New History of the World's Most Prosperous Decade.
By Joseph E. Stiglitz.
W. W. Norton; 256 pages; $25.95. Penguin/Allen Lane; £18.99

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About sponsorship

South Africa

A long decade

Sep 18th 2003
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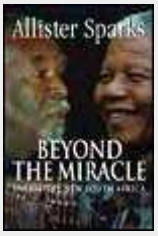
FOR two years after he became South Africa's deputy president, Thabo Mbeki did not bother to visit his mother, a shopkeeper in a small town in the Eastern Cape. He then paid her a half-hour visit by helicopter. It is a trivial detail, but readers will be glad that Allister Sparks has not, after 52 years of writing about South Africa, lost his eagle eye. A former editor of the *Rand Daily Mail* (and a former contributor to *The Economist*), Mr Sparks provides a generous but critical account of how his countrymen have coped during the nine years since apartheid ended.

Beyond the Miracle: Inside the New South Africa
By Allister Sparks



University of Chicago Press; 368 pages; $32.50. Profile Books; £14.99

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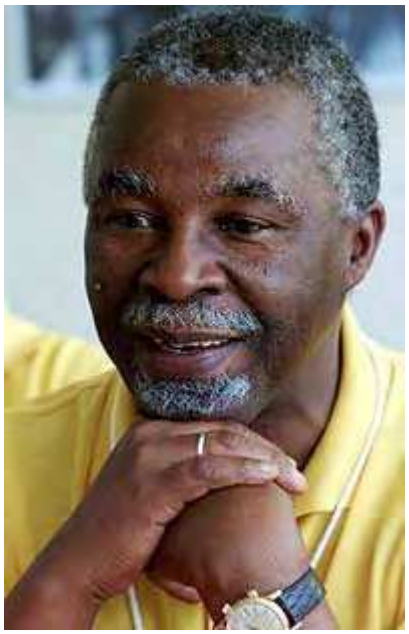
The most compelling figure in the drama is Mr Mbeki, now South Africa's president. He is a curious man, best known for seeming to suggest that HIV/AIDS, which is devastating South Africa, and Robert Mugabe, who is devastating its most important neighbour, are both harmless. Outsiders are baffled. Mr Sparks tries gamely to unbaffle them.

He traces some of Mr Mbeki's quirks back to his bizarre upbringing. Sent into exile as a teenager, he was raised, less by a family than by a political party, the African National Congress (ANC). Exile politics bred paranoia, for apartheid agents often infiltrated the exiled revolutionaries' ranks, with lethal consequences. Perhaps this is why Mr Mbeki now chooses his advisers more for their longstanding loyalty than for their ability, why he sees plots where others see none, and why he is so obsessed with controlling information.

Mr Sparks applauds Mr Mbeki's intelligence, but wonders whether he is wise to try to “become an expert on every subject his government has to deal with”. He frets, too, about Mr Mbeki's “manipulative style of operating”. “Thabo sends you obscure messages,” says an ANC colleague, “and if you don't read them right you can find yourself dead in the morning—and there'll be no fingerprints.”

Not literally, of course. South Africa is not Zimbabwe. Public outcry has obliged Mr Mbeki to “withdraw from the debate” on HIV/AIDS, and to allow South African hospitals to start offering conventional drug therapy for the disease, which would make no sense if HIV did not cause it.

Reuters



Hard to read

Mr Sparks reckons that civil society in South Africa forms a “strong counterweight against the kind of egocentric tyranny so many other African countries have suffered.” He predicts that when Mr Mbeki is safely into his second (and last) term, “his inner insecurities will subside and the great potential that is undoubtedly within him will blossom.”

“Beyond the Miracle” is Mr Sparks's third book, and although it is not quite as brilliant as “The Mind of South Africa”, it is still pretty good. Its chief weakness is that Mr Sparks's analysis of the rest of the world is less sharp than that of his homeland. Did “competition from communism” before the 1990s really “temper [the] avarice” of capitalism? And does South Africa's racial and socio-economic mix really make it “the test case for a new global dispensation”? But let's not carp. It is as good a guide to the new South Africa as any.

Beyond the Miracle: Inside the New South Africa.
By Allister Sparks.

University of Chicago Press; 368 pages; $32.50. Profile Books; £14.99

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About sponsorship

Second world war

The worst battle

Sep 18th 2003
From The Economist print edition

MOST of the great battles of the second world war have been well chronicled in millions of battle-hardened words, allowing a reader to experience their fury from the safety of an armchair: Stalingrad, Berlin, Normandy, the battle of Britain. Now here is Monte Cassino, perhaps the most interesting campaign of all. It lasted six months, a quarter of a million soldiers died or were wounded and probably it should never have been fought.

Monte Cassino: The Hardest-Fought Battle of World War Two
By Matthew Parker

Headline; 480 pages; £20

Buy it at
Amazon.co.uk

In 1943, the fourth year of the war, the Americans wanted to get on with the invasion of Europe, across the Channel from Britain to Normandy, through France and into Germany. But Britain believed the allies were not yet ready to take on the Germans, a wise assessment as it turned out: when the invasion did take place in 1944 after great preparation, it was no walkover.

But the question that bothered the generals was what to do with large numbers of idle soldiers until D-day. Winston Churchill proposed an assault on Italy. Ever the phrasemaker, he said Italy was the soft underbelly of Europe. So at first it seemed. Sicily soon fell, the Italian leader, Benito Mussolini, was deposed and an easy landing was made by the allies on the Italian mainland. The allies set off northwards to Rome. But, as Matthew Parker notes, Rome had not been taken from the south since AD536, when Belisarius, a Byzantine general, managed it. Even Hannibal preferred to cross the Alps with his elephants rather than face the geography south of Rome. “Italy is a boot,” Napoleon said. “You have to enter it from the top.”

Still, with most of the Italian army surrendering, the allies thought they could look forward to an easy ride to the eternal city. But the Germans fought on under their formidable commander, Field Marshal Albert Kesselring. He made his stand along a line stretching across Italy from coast to coast, most of it mountainous and bisected by fast-flowing rivers. At the centre of one of Europe's strongest natural defensive positions was Monte Cassino, the site of an ancient Benedictine monastery.

The Germans said they were not occupying the monastery, but the allies did not believe them: anyway, it had become a malign presence, “the all-seeing eye”, as one soldier described it. By the start of 1944, when attacks on the Germans had failed with massive allied casualties, it was decided to bomb the monastery, despite pleas from the Vatican for it to be spared. In Britain there were some who agreed, saying it would be like bombing Westminster Abbey. The allied commander, General Sir Howard Alexander, said that “bricks and mortar, no matter how venerable, cannot be allowed to weigh against human lives.”

On February 15th 1944 bombers turned the monastery into rubble, providing the Germans with new defences when the allies staged an assault exactly a month later. The Germans held on until May. In June the allies finally entered Rome, which would soon have fallen anyway: the invasion of Normandy, the decisive battle for Europe, started a few days later.

Monte Cassino was the closest the war came to the attrition warfare of the first world war that, as Mr Parker observes, the generals hoped to avoid, relying more on technology than the bayonet. In that sense, Monte Cassino was the worst battle. The terrain and the weather conspired to make technology useless. In his moving and well-researched book Mr Parker takes note of many earlier accounts of the fighting at Monte Cassino and has in addition interviewed many veterans who still vividly, and bitterly, remember the battle of long ago.

He is clearly on the side of the foot-soldier trying to obey demanding superiors. As in the trenches of

Flanders, there was sometimes an unwarlike camaraderie between German and allied soldiers. During a truce agreed by the Germans so that the Americans could collect their dead and wounded, an American corporal recalled, “This German came to our side, and I gave him a cigarette. I talked to him for just a few minutes. He talked pretty good English. He said he had a brother in Brooklyn named Heinz.” The atmosphere was friendly, he said, and the Germans were anxious to help. Then the truce was over, and the two sides resumed killing each other.

Monte Cassino: The Hardest-Fought Battle of World War Two.
By Matthew Parker.
Headline; 480 pages; £20

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The electric chair

Seat of faith

Sep 18th 2003
From The Economist print edition

Get article background

FOR nearly two centuries America has struggled to reconcile its affection for the death penalty with its image of itself as a humane and just society. Few episodes in this long history have been as strange as the one told by Mark Essig in his new book, “Edison & the Electric Chair”. To describe Mr Essig's tale as shocking would be in poor taste, but its odd mixture of technology-worship, industrial sabotage, judicial complacency and rank hypocrisy should at least make American readers a bit queasy about their continued support for capital punishment.

In the 19th century America had grown to dislike hanging, the usual method of executing condemned prisoners. Hangings often took place in public, frequently leading to riots and other unseemly behaviour among spectators. Hangings also were often botched, resulting in slow strangulation or decapitation. Opponents of the death penalty gained adherents by arguing that hanging was cruel and barbaric. To restore respectability to executions, supporters of the death penalty came up with the idea of electrocution.

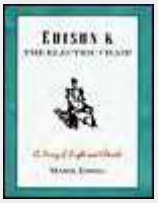
Electricity was a new and glamorous technology. It was, above all, modern. At the same time, it made people nervous. America was just beginning to wire up its major cities, and although the benefits of electric light were obvious to everyone, no one was quite sure how safe it was. After surveying execution methods from the guillotine (too bloody) to morphine overdoses (too pleasant), a commission appointed by the New York state legislature recommended in 1888 the use of electrocution, which it promised would be “instantaneous and painless” and “devoid of all barbarism”. The man who had persuaded the commission of this was Thomas Edison, America's most famous inventor.

Edison's primary interest in recommending electrocution was to discredit his chief rival in the race to wire America, George Westinghouse. Edison's company used direct current. Westinghouse's firm used alternating current. Edison not only argued that electrocution would be the best new way to kill condemned prisoners, but that Westinghouse's alternating current would be better at it than his own direct current. In other words, his support for electrocution was a marketing ploy. Edison hoped that using alternating current for executions would indelibly associate it with death in the public mind, and give him an edge in the electricity market.

Westinghouse responded by secretly hiring a high-profile lawyer to defend the first defendant selected by the state of New York to sit in the electric chair and, after he was convicted, to appeal against the use of the chair all the way to the Supreme Court. Mr Essig's book reads like a good novel, and so relating what happened next would be unfair. But two observations are in order. The first is that electrocution was so horrific that it made a number of the official witnesses vomit and faint; it took two tries to kill Martha Place, the first woman to die in the electric chair, in 1899. Secondly, more than 100 years after that execution, America is still wrestling with the rights, wrongs and aesthetics of capital punishment.

Edison & the Electric Chair: A Story of Light and Death.
By Mark Essig.
Walker & Company; 368 pages; $26. To be published in Britain by Sutton Publishing in November

Edison & the Electric Chair: A Story of Light and Death
By Mark Essig



Walker & Company; 368 pages; $26. To be published in Britain by Sutton Publishing in November

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New fiction

Dust to dust

Sep 18th 2003
From The Economist print edition

OF THE six novels shortlisted for this year's Man Booker prize for fiction, easily the most subversive is Damon Galgut's “The Good Doctor”. Set in a former South African homeland, in a rural hospital so poor that it has no medicines and no patients either, the novel spells out in fiction what no South African, black or white, would dare even whisper among friends: that South Africa run by Africans is going to hell in a handbasket.

The hospital is run by Dr Ngema, a woman so uncomfortable with her elevated status that she cannot bear the slightest change in routine. There is a pair of squabbling Cuban doctors; Tehogo, a thieving African technician; and the narrator, a newly divorced, vacant white doctor named Frank who seeks oblivion by copulating—you can't call it making love—with a poor African woman from the local village. She tells him she's called Maria, but none of the villagers use that name.

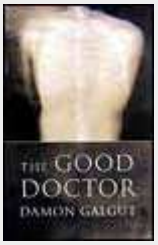
Enter Laurence, a bright-eyed newly qualified medic, who has applied to work in this hospital precisely because it is so poor and so remote. Undaunted and undauntable, Laurence is the ubiquitous do-gooder, all smiles and Teva sandals and mad keen on clinics.

Dr Ngema insists that Laurence and Frank share a room, an odd arrangement given that the one thing the hospital has in abundance is empty beds. But it does bring the two men into confrontation. In the end, Dr Ngema is transferred elsewhere to befuddle an even bigger hospital, poor Tehogo dies, the used-up Maria vanishes, as does Laurence goody-two-shoes. Frank, who has turned out to be a disappointment to his parents and his wife, though not, oddly, to himself, becomes boss of the hospital, and lives out his days in purposeless vacancy.

The passing of apartheid robbed South Africa's white novelists of a great artistic cause. Some, like Nadine Gordimer, J.M. Coetzee and André Brink, are trying to reinvent themselves. Of the younger generation, Mr Galgut, with his spare, unhurried sentences, his carefully chosen words, is the most talented—and the saddest.

The Good Doctor.
By Damon Galgut.
Atlantic Books; 216 pages; £10.99. To be published in America by Grove Press in March 2004

The Good Doctor
By Damon Galgut



Atlantic Books; 216 pages; £10.99. To be published in America by Grove Press in March 2004

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Pre-Raphaelite painting

More than just a gorgeous face

Sep 18th 2003
From The Economist print edition

Pretty or pretty amazing? Victorian art enjoys a new heyday

Andrew's little flame of love

THE Pre-Raphaelites have come a long way since Andrew Lloyd Webber's grandmother refused to lend him £50 ($75) to buy Lord Leighton's “Flaming June” in the early 1960s because, she said, she didn't want any Victorian junk in her flat. That masterpiece ended up in a Puerto Rico museum and is now worth millions; the composer of musicals became a lord and made enough money so he never had to forgo a painting again.

Four decades on, the cream of Lord Lloyd-Webber's collection of Victorian paintings, ceramics, carpets, tapestries and furniture, which he has just announced he is bequeathing to Britain on his death, goes on show at London's Royal Academy of Arts. The first survey in a generation of Dante Gabriel Rossetti's work is at the Walker art gallery in Liverpool and William Morris's Red House was opened in July by the National Trust. Why did the British love and then loathe Victorian art so—and why is it now making such a comeback?

Hot lips

Part of the answer may be found by looking closely at the RA's exhibition poster, which features Rossetti's lush “A Vision of Fiammetta”, one of Lord Lloyd-Webber's most treasured works. Inspired by a Boccaccio sonnet, it depicts an idealised woman, ripe as a fruit and surrounded by apple blossoms—symbols of a love that transcends death. The Pre-Raphaelites were obsessed with revealing spiritual beauty, which is why the preternatural prettiness of the painting, with its melodramatic curved lips and its poetic narrative, produces a visual shock to the system whether one likes it or not.

This is precisely what the Pre-Raphaelite painters wanted their viewers to feel. Founded in 1848, a year that is synonymous with European revolt, the Pre-Raphaelite Brotherhood was self-consciously revolutionary in its aims. Its members fought against what they saw as corrupt academic art based on the work of the Renaissance. They despised Raphael, whom they believed had led art astray from its spiritual beginnings. Instead, they set out to imitate what they regarded as the unaffected grace of the often anonymous artists who preceded him.

Rossetti, the child of Italian political refugees, was a founding member of the Pre-Raphaelites, along with John Everett Millais, Holman Hunt and later Ford Madox Brown, Edward Coley Burne-Jones and Frederic Stephens. Their reverence for medieval craftsmanship attracted a kindred spirit in William Morris, who led the Arts and Crafts movement in decorative arts and architecture, and worked with many of the artists on projects for the-then brand new Victoria and Albert museum.

At first, the Pre-Raphaelites' idiosyncratic mix of nostalgia and intense realism was derided as freakish. But once John Ruskin began publicly championing their work in 1851, they gained a popular following, particularly among the growing middle classes who identified with their moralising aims. The artists turned their paintings into contemporary fables based on history and literature, myth and religion, and—most radically—on the injustices they saw around them. One favourite subject was the fallen woman, whom they saw as a symbol of lost innocence.

Rossetti's “Found” depicts a young farmer coming to the city and finding that his lost first love has become a prostitute and is dying in the street. Burne-Jones painted the face of his spurned mistress into myriad images of tragic love. Holman Hunt's “The Awakening Conscience” depicts a mistress in the lap of her lover discovering too late the error of her ways. Although today their art can appear conservative and misogynistic, the Pre-Raphaelites firmly believed that by revealing what they regarded as the despoilment of natural beauty and moral values in a world that was increasingly industrialised their art could help make that world a better place.

As Richard Dorment points out in the catalogue to the Lloyd Webber exhibition, Pre-Raphaelite art began to lose its allure in 1895 when Oscar Wilde's trial cut short the flowering of British romantic painting. After his imprisonment, a generation of symbolist artists and aesthetes—including James Whistler, Aubrey Beardsley and Walter Sickert—abandoned Britain for France, leaving a vacuum in British art that was ultimately filled by Post-Impressionism and Modernism. The triumph of new art from France virtually snuffed out the British poet-painter tradition that had run from William Blake through Rossetti, Burne-Jones and later Beardsley. After the first world war finally laid Victorian art to rest, the Pre-Raphaelites' most vociferous critics came from the Bloomsbury group, above all Roger Fry, who lambasted their work as decadent and mawkish.

Hippy heaven

By the 1970s, the tide started to turn. American buyers, such as Huntington Hartford and Christopher Forbes amassed large collections. Victorian art fit the post-hippy tempo and posters of J.M. Waterhouse's “The Lady of Shalott”, singing her last song and looking for all the world like a medieval Marianne Faithfull, adorned infinite numbers of university dorms.

Today many British artists look to Victorian art for its perversity as well as its beauty. In a recent interview, Paula Rego, a painter known for her warped visions of fairytales, said she loves the exquisite detail and directness of Victorian art: “You just go straight into the picture. There's no looking at art with a big A.” Anya Gallaccio, nominated for this year's Turner prize at the Tate, has made a self-portrait as Millais's “Ophelia”, while a fellow Turner prize nominee, Grayson Perry, seems obsessed with the upholstered women of the Victorian fashions that appear in the paintings.

Above all, the strong narrative of Victorian art appeals to the universal popularity of a good story. Their Harry Potter was Alice in Wonderland. In an age when spin and spam contaminate daily life, Victorian art allows people to fantasise about an ideal other world, not all that distant from our own.

“Pre-Raphaelite and Other Masters: The Andrew Lloyd Webber Collection” is at the Royal Academy of Arts, London, until December 12th.

“Dante Gabriel Rossetti” is at the Walker art gallery, Liverpool, from October 16th-January 18th 2004.

William Morris's Red House, Bexleyheath, Kent: see www.nationaltrust.org.uk for opening times

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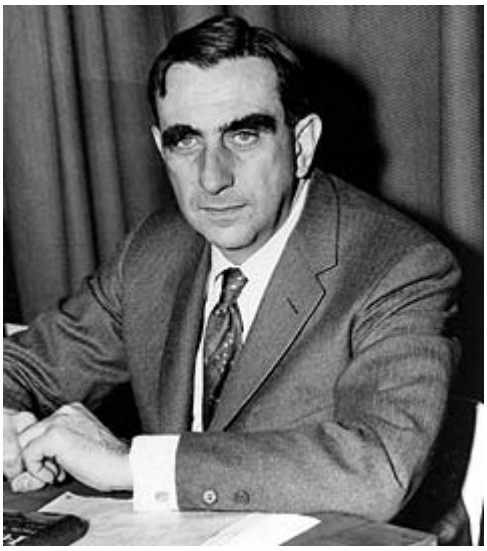
About sponsorship

Edward Teller

Sep 18th 2003
From The Economist print edition

Edward Teller, master bombmaker, died on September 9th, aged 95

AP



AT SEVEN in the morning of November 1st 1952 the United States exploded a device over the Pacific that came to be called the hydrogen bomb. According to a witness, the massive fireball produced by the explosion spread so far that it terrified even experienced observers. The entire island of Elugelab, a mile in diameter, disappeared. One of the organisers of the event was so unnerved that he argued that the magnitude of the blast, more than 500 times that of the bomb that had destroyed Hiroshima in 1945, should be kept a secret.

However, everyone, it seems, got over the terror. The world was not going to be blown up. Two years later another, even bigger bomb was set off close to Bikini atoll, making it as scanty as the garment it gave its name to. The Russians made their own H-bomb. Soon the bomb in various forms became a standard weapon in the arsenals of America, Russia and other countries.

Edward Teller has been called the father of the H-bomb. Mr Teller, described by one writer as having a doom-laden voice whose words were like “great marble blocks”, did occasionally allow himself a joke and said that all he had fathered was two children. He believed the development of the H-bomb was inevitable. That may be true, but Mr Teller pushed the inevitability forward. Perhaps more than anyone he pursued its “sweet technology”. He was a patriot; more than that, he was imbued with a fierce patriotism that seems to be a characteristic of immigrants who have totally and gratefully embraced America. His native Hungary suffered fascist rule in the years before the second world war and communist rule afterwards. America was the world's shining shield against tyranny. The H-bomb was its trusty sword.

Questions of morality

Edward Teller felt some sympathy for the politicians who had to decide whether to proceed with these fearsome weapons with no more than the vaguest idea how they worked. For Harry Truman, who gave the order for the atomic bomb to be dropped on Hiroshima and later to proceed with the development of the H-bomb, mathematics was the sums he had used to price goods in the draper's shop he had run before going into politics. What sort of questions could he be expected to put to atomic scientists without some grasp of quantum theory? No doubt quite simple ones. Will the bomb work? What damage will it do? In the end, Mr Teller had to accept that in the eyes of his president he was simply a master bombmaker.

Had Truman sought guidance on the morality of using the bomb, he would have been offered conflicting views. Mr Teller was among the scientists who argued in 1945 against destroying a Japanese city. He wanted the first atomic bomb to be exploded high above Tokyo where its power would be demonstrated. It would light up the sky but do no damage. But Robert Oppenheimer, who was in charge of the building of the bomb, did not agree. Later, having “tasted sin”, as he put it, Oppenheimer opposed the development of the H-bomb, saying that the earlier bomb was powerful enough for any possible military purpose.

As a result of Oppenheimer's opposition to the H-bomb he was suspected of being disloyal. At a time of communist witch-hunts, it was recalled that he had had leftist sympathies. After Mr Teller declined to give wholehearted support to his former chief, Oppenheimer was considered no longer suitable to share

his country's secrets and his career as a government scientist came to an end. He died in 1967, aged 62.

Mr Teller, though, had years of work ahead in military science. People liked to have his assurance that America could survive a nuclear attack. He said that the balance of terror between the nuclear superpowers was preferable to trusting the communists: he tended to be against negotiations designed to reduce stocks of arms. He had stories dating back to before some of his admirers were born, such as the time in 1939 when he and Leo Szilard, another Hungarian scientist, persuaded Albert Einstein to write to President Roosevelt, urging the need to make an atomic bomb before the Germans did.

He was a favourite of Ronald Reagan, whose election, Mr Teller said, was a “miracle” for western civilisation. Mr Reagan's knowledge of maths was even less than Truman's, but he had watched space movies. When Mr Teller speculated that a defensive shield could be constructed in space to destroy an attack by missiles, Mr Reagan was immediately enthusiastic. “Star Wars” was born. Although Star Wars was a dud as a military weapon, “economic wars” were having some success. Star Wars disheartened the Russians, who were already going bust as a result of trying to keep up with American arms spending. So the idea may have hastened the break-up of the Soviet Union.

Mr Teller lived modestly. His pleasures were playing the piano and table tennis. But he got America to spend billions upon billions of dollars on weapons, on underground shelters that he believed could save most people in a nuclear attack and on Star Wars. Most of it is junk now, but if such extravagance helped to beat the Russians, why should he be sorry?

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Overview

Sep 18th 2003
From The Economist print edition

America's **Federal Reserve** left interest rates unchanged at 1.0%. The Fed's statement said that the central bank has changed its assessment of the labour market from “mixed” to “weak”. Consumer confidence, as measured by preliminary September figures from the University of Michigan, fell to a five-month low thanks to concerns over joblessness. Jobless claims rose to 422,000.

America's **industrial production** grew by a mere 0.1% in August, compared with a rise of 0.7% in July, a figure that was revised up from 0.5%. Declining car manufacturing (worsened by the electrical blackout in the north-east) in August was one reason for the sluggishness. Another was a 3.1% fall in metals production.

America's goods and services **trade deficit** rose to $40.3 billion in July from $40.0 billion in June.

Consumer prices in America rose by 0.3% in August; **inflation** in the year to August ran at 2.2%, inching up from 2.1% in the year to July. Yet there still may be grounds to worry about deflation: core CPI (which excludes prices for energy and food) growth fell to 1.3% in the year to August, the lowest annual rate since 1966.

Industrial production in the **euro area** rose by 0.6% in July, thanks in part to strengthening output from German factories. Even so, euro-area industrial production is down by 0.3% in the year to August. **Germany's** ZEW index of business confidence climbed to 60.9 in September, its ninth straight month of increase. Industrial production in **France** fell by 1.1% in the year to July.

Unemployment in **Sweden** climbed to 5.4% in August, up from 5.0% in July.

Britain's retail price index (RPI) rose by 0.2% in August. In the year to August, consumer prices rose by 2.9%, down from 3.1% in the year to July. The RPIX measure, which excludes mortgage interest payments, rose by 0.3% in August, giving a 12-month inflation rate of 2.9%. August was the tenth straight month in which RPIX exceeded the government's 2.5% target. Unemployment fell in Britain, and employment rose to a record high, yet the ILO's measure of unemployment edged up to 5.1%.

Japanese industrial production fell by a revised 0.3% in the year to July. Bankruptcies in Japan fell by 15% in August.

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Output, demand and jobs

Sep 18th 2003
From The Economist print edition

% change on year ago

	GDP latest		GDP qtr*	The Economist poll GDP forecasts 2003	2004	Industrial production latest		Retail sales (volume) latest		Unemployment % rate latest		year ago
Australia	+ 2.0	Q2	+ 0.5	+ 2.8	+ 3.5	nil	Q1	+ 3.6	Q2	5.8	Aug	6.2
Austria	+ 1.0	Q1	+ 0.7	+ 0.5	+ 1.4	– 1.9	Dec	– 0.5	Jun	4.5	Jul	4.3
Belgium	+ 0.8	Q2	– 0.4	+ 0.7	+ 1.6	– 5.9	Jun	– 1.7	Jun	13.3	Aug†	12.0
Britain	+ 1.8	Q2	+ 1.3	+ 1.8	+ 2.4	– 0.5	Jul	+ 3.8	Aug	5.1	Jul††	5.0
Canada	+ 1.6	Q2	– 0.3	+ 2.2	+ 3.0	+ 0.5	Jun	+ 2.3	Jun	8.0	Aug	7.5
Denmark	– 0.8	Q2	– 1.8	+ 1.1	+ 2.1	+ 1.6	Jul	+ 2.2	Jun	6.0	Jul	5.1
France	nil	Q2	– 1.3	+ 0.7	+ 1.9	– 1.1	Jul	– 2.2	May	9.6	Jul	9.1
Germany	– 0.2	Q2	– 0.2	nil	+ 1.3	+ 0.5	Jul	– 2.4	Jul‡	10.6	Aug§	9.8
Italy	+ 0.3	Q2	– 0.3	+ 0.5	+ 1.6	– 1.7	Jun	– 2.1	Jun	8.7	Apr	9.0
Japan	+ 3.0	Q2	+ 3.9	+ 1.5	+ 1.3	– 0.3	Jul	– 2.6	Jul	5.3	Jul	5.4
Netherlands	– 0.9	Q2	– 2.1	– 0.2	+ 1.4	– 3.2	Jun	– 1.1	Apr	5.3	Aug**	4.2
Spain	+ 2.3	Q2	+ 2.7	+ 1.9	+ 2.6	+ 1.7	Jul	+ 3.6	Jul	11.4	Jul	11.3
Sweden	+ 1.3	Q2	+ 1.2	+ 1.5	+ 2.2	+ 2.5	Jul	+ 5.0	Jul	5.4	Aug†	4.1
Switzerland	– 1.0	Q2	– 1.2	– 0.1	+ 1.3	+ 0.9	Q1	– 1.7	Jun	3.6	Aug†	2.4
United States	+ 2.5	Q2	+ 3.1	+ 2.4	+ 3.6	– 1.0	Aug	+ 6.3	Jul	6.1	Aug	5.8
Euro area	+ 0.2	Q2	– 0.3	+ 0.5	+ 1.7	– 0.3	Jul	+ 0.7	Jun	8.9	Jul	8.4
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*											
Finland	+ 0.8	Q2	+ 2.4	na	na	+ 1.9	Jul	+ 2.2	Jun	7.7	Aug†	8.1
Greece	+ 4.5	Q2	+ 0.4	na	na	+ 2.1	Jul	na		na		na
Iceland	+ 2.7	Q2	na	na	na	– 0.3	2002	na		3.0	Jul†	2.3
Ireland	+ 0.5	Q1	na	na	na	+10.7	Jul	+ 2.9	Jun	4.5	Aug	4.3
Luxembourg	+ 1.1	2002	na	na	na	– 3.6	Jun	– 1.6	Mar	3.7	Jul	2.8
New Zealand	+ 3.6	Q1	+ 3.3	na	na	+ 4.2	Q1	+ 5.1	Q2	4.7	Q2	5.2
Norway	– 2.0	Q2	– 0.6	na	na	– 2.8	Jul	+ 5.7	Jul	4.7	Q2	4.0
Portugal	– 2.3	Q2	+ 0.5	na	na	– 0.8	Jul	+ 1.0	Jul	6.2	Q2†	4.5

*% change on previous quarter at an annual rate. †Not seasonally adjusted. ‡New series. ††May-Jul; claimant count rate 3.1% in Aug. §EU harmonised rate 9.4% in Aug. **Jun-Aug.

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Prices and wages

Sep 18th 2003
From The Economist print edition

% change on year ago

	Consumer prices			The Economist poll consumer prices forecast		Producer prices			Wages/earnings		
	latest		year ago	2003	2004	latest		year ago	latest		year ago
Australia	+ 2.7	Q2	+ 2.8	+ 2.7	+ 2.3	+ 0.2	Q2	– 1.1	+ 5.5	Q2	+ 3.7
Austria	+ 1.1	Aug	+ 1.9	+ 1.3	+ 1.1	+ 1.3	Aug	– 0.6	+ 2.1	Jul	+ 2.4
Belgium	+ 1.8	Aug	+ 1.3	+ 1.3	+ 1.1	– 1.9	Jul	+ 0.5	+ 1.7	Q2	+ 2.6
Britain	+ 2.9	Aug	+ 1.4	+ 2.7	+ 2.4	+ 1.6	Aug	+ 0.4	+ 3.4	Jul	+ 3.9
Canada	+ 2.2	Jul	+ 2.1	+ 2.8	+ 1.9	– 1.6	Jul	– 0.2	+ 3.8	Jun	+ 2.9
Denmark	+ 1.7	Aug	+ 2.3	+ 2.2	+ 1.8	– 0.3	Aug	– 0.4	+ 3.8	Q2	+ 3.7
France	+ 1.9	Aug	+ 1.8	+ 1.8	+ 1.3	+ 0.9	Jun	– 1.4	+ 2.7	Q2	+ 3.9
Germany	+ 1.1	Aug	+ 1.2	+ 0.9	+ 0.6	+ 0.8	Aug	– 0.5	+ 1.8	Jun	+ 3.0
Italy	+ 2.8	Aug	+ 2.4	+ 2.5	+ 1.9	+ 1.3	Jul	+ 0.4	+ 2.1	Jul	+ 2.2
Japan	– 0.2	Jul	– 0.8	– 0.4	– 0.3	– 0.6	Aug	– 2.0	+ 2.8	Jul	– 5.1
Netherlands	+ 2.1	Aug	+ 3.3	+ 2.3	+ 1.8	+ 1.9	Jul	– 0.3	+ 2.0	Jul	+ 3.4
Spain	+ 3.0	Aug	+ 3.6	+ 3.0	+ 2.5	+ 1.1	Jul	+ 0.4	+ 4.9	Q1	+ 4.0
Sweden	+ 1.7	Aug	+ 2.0	+ 2.2	+ 1.6	– 1.5	Jul	– 0.8	+ 3.3	Jun	+ 3.1
Switzerland	+ 0.5	Aug	+ 0.5	+ 0.6	+ 0.6	– 0.3	Aug	– 1.4	+ 1.8	2002	+ 2.5
United States	+ 2.2	Aug	+ 1.8	+ 2.2	+ 1.3	+ 3.4	Aug	– 1.5	+ 2.9	Aug	+ 3.0
Euro area	+ 2.1	Aug	+ 2.1	+ 1.8	+ 1.3	+ 1.3	Jul	– 0.3	+ 3.0	Q1	+ 3.3
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*										
Finland	+ 0.6	Aug	+ 1.4	na	na	– 0.1	Aug	– 1.8	+ 4.3	Q2	+ 3.9
Greece	+ 3.3	Aug	+ 3.5	na	na	+ 2.9	Jul	+ 0.9	na		na
Iceland	+ 2.0	Aug	+ 3.2	na	na	+ 3.0	Sep	+ 6.2	+ 5.7	Jul	+ 6.6
Ireland	+ 3.2	Aug	+ 4.5	na	na	– 8.2	Jul	– 3.8	+ 7.1	Q1	+ 6.9
Luxembourg	+ 2.0	Aug	+ 1.8	na	na	+ 2.1	Jun	– 1.3	nil	Jun	– 0.6
New Zealand	+ 1.5	Q2	+ 2.8	na	na	– 2.0	Q2	+ 1.5	+ 2.3	Q2	+ 2.1
Norway	+ 2.1	Aug	+ 1.4	na	na	+ 6.1	Aug	– 8.6	+ 5.4	Q2	+ 4.9
Portugal	+ 2.8	Aug	+ 3.7	na	na	– 0.4	Jul	+ 0.5	nil	Jun	+ 0.5

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University-level qualifications

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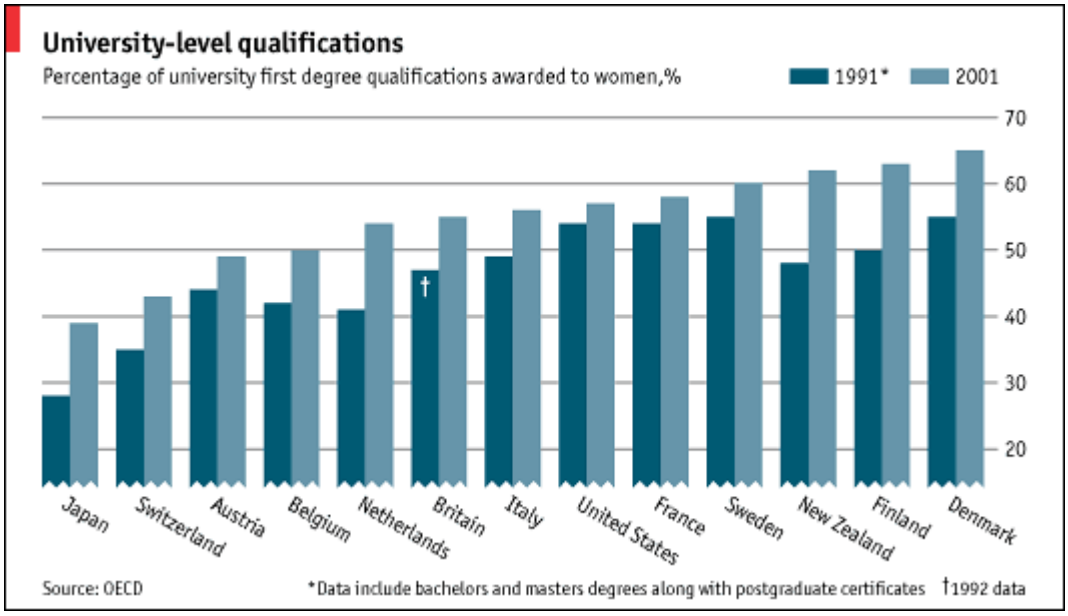
From The Economist print edition



In most rich countries, more women than men are now awarded first degrees from universities, according to the OECD. Nine of the thirteen countries shown in our chart saw women receive a higher proportion of first degrees than men in 2001, compared with just four in 1991. Only in Switzerland, Japan and Austria did men receive more such qualifications than women in 2001.

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Money and interest rates

Sep 18th 2003
From The Economist print edition

	Money supply* % change on year ago			Interest rates % p.a. (Sep 17th 2003)					
				3-mth money market		2-year	10-year gov't bonds		corporate
	narrow	broad		latest	year ago	gov't bonds	latest	year ago	bonds
Australia	+ 9.5	+13.5	Jul	4.95	4.95	5.05	5.56	5.47	6.26
Britain	+ 8.1	+ 7.5	Jul	3.63	3.94	4.21	4.65	4.41	5.74
Canada	+ 9.4	+ 6.9	Jul	2.65	2.82	3.01	4.77	4.86	6.55
Denmark	+ 8.7	+ 9.8	Jul	2.30	3.40	2.80	4.34	4.54	5.56
Japan	+ 5.5	+ 2.0	Aug	0.01	0.02	0.13	1.44	1.22	1.56
Sweden	+ 3.4	+ 5.1	Jul	2.71	4.13	3.24	4.70	4.81	3.86
Switzerland	+24.8	+ 9.9	Aug	0.25	0.73	0.08	2.70	2.51	2.86
United States	+ 8.6	+ 8.0	Aug	1.08	1.77	1.60	4.19	3.85	6.00
Euro area†	+11.5	+ 8.5	Jul	2.15	3.31	2.44	4.25	4.29	4.11

*Narrow: M1 except Britain and Sweden M0, broad: M2 or M3 except Britain M4. †Germany for bonds. Benchmarks: US 30-year 5.10%, Japan No.253 1.43%. Central bank rates: US fed funds 1.00%, ECB refinancing 2.00%, BOJ overnight call 0.001%, BOE repo 3.5%. Sources: Commerzbank, Danske Bank, J.P. Morgan Chase, Royal Bank of Canada, Stockholmsbörsen, UBS, Global Insight, Westpac, Thomson Datastream. Rates cannot be construed as banks' offers.

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The Economist commodity price index

Sep 18th 2003
From The Economist print edition

1995=100

	Sep 9th	Sep 16th*	% change on one month	% change on one year
Dollar index				
All items	81.0	79.8	+ 1.9	+ 5.7
Food	81.1	79.1	+ 2.0	– 2.9
Industrials				
All	80.9	80.8	+ 1.8	+19.6
Nfa†	86.3	87.2	+ 5.5	+25.6
Metals	76.4	75.3	– 1.6	+14.3
Sterling index				
All items	80.4	79.2	+ 1.6	+ 2.1
Euro index				
All items	95.3	93.8	+ 1.0	– 8.5
Yen index				
All items	100.3	98.9	– 0.7	+ 0.5
Gold				
$ per oz	381.00	372.50	+ 3.2	+17.7
West Texas Intermediate				
$ per barrel	29.15	27.58	–10.3	– 5.3

* Provisional. † Non-food agriculturals.

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Stockmarkets

Sep 18th 2003
From The Economist print edition

Market indices

	Sep 17th	2003 high	2003 low	% change on one week	% change on record high	% change on Dec 31st 2002 in local currency	% change on Dec 31st 2002 in $ terms
Australia (All Ordinaries)	3,221.5	3,237.5	2,673.3	nil	– 6.4	+ 8.3	+27.7
Austria (ATX)	1,361.3	1,382.4	1,120.2	– 0.7	–21.6	+18.4	+26.8
Belgium (Bel 20)	2,122.0	2,122.0	1,426.6	+ 2.4	–42.4	+ 4.8	+12.2
Britain (FTSE 100)	4,293.0	4,299.0	3,287.0	+ 1.0	–38.1	+ 8.9	+ 8.5
Canada (Toronto Composite)	7,613.6	7,636.0	6,228.6	+ 0.6	–33.1	+15.1	+33.0
Denmark (KBX)	214.0	217.5	145.0	+ 1.7	–29.1	+28.7	+37.8
France (SBF 250)	2,304.6	2,318.0	1,630.1	+ 2.0	–47.5	+12.2	+20.2
(CAC 40)	3,393.9	3,422.8	2,403.0	+ 2.0	–51.0	+10.8	+18.6
Germany (DAX)	3,561.0	3,668.7	2,203.0	+ 0.7	–55.8	+23.1	+31.8
Italy (BCI)	1,207.9	1,213.7	959.4	+ 0.8	–44.6	+10.6	+18.5
Japan (Nikkei 225)	10,990.1	10,990.1	7,607.9	+ 1.2	–71.8	+28.1	+30.7
(Topix)	1,072.6	1,072.6	770.6	+ 2.7	–62.8	+27.2	+29.8
Netherlands (AEX)	337.4	342.2	218.4	+ 1.9	–51.9	+ 4.5	+11.9
Spain (Madrid SE)	756.7	768.6	576.8	+ 0.8	–34.0	+19.4	+27.8
Sweden (Affarsvarlden Gen)	179.2	180.4	127.8	+ 1.6	–55.2	+23.4	+33.4
Switzerland (Swiss Market)	5,398.9	5,398.9	3,675.4	+ 1.7	–35.8	+16.6	+16.6
United States (DJIA)	9,545.7	9,587.9	7,524.1	+ 1.3	–18.6	+14.4	+14.4
(S&P 500)	1,026.0	1,031.6	800.7	+ 1.5	–32.8	+16.6	+16.6
(NASDAQ Comp)	1,883.1	1,888.6	1,271.5	+ 3.3	–62.7	+41.0	+41.0
Europe (FTSE Eurotop 300)*	916.6	926.5	682.7	+ 1.4	–46.2	+ 7.0	+14.5
Euro area (FTSE Ebloc 100)*	786.0	800.8	565.7	+ 1.1	–49.3	+ 9.4	+17.2
World (MSCI)†	933.3	933.3	710.8	+ 1.7	–35.6	na	+17.8
World bond market (Citigroup)‡	552.3	583.9	518.6	+ 0.8	– 5.4	na	+ 5.1

*In euro terms. †Morgan Stanley Capital International index includes individual markets listed above plus eight others, in dollar terms.
‡Citigroup World Government Bond Index, total return, in $ terms.

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Trade, exchange rates and budgets

Sep 18th 2003
From The Economist print edition

	Trade balance*, $bn latest 12 months		Current account $bn latest 12 mths		The Economist poll % of GDP, forecast 2003	2004	Exchange rate trade-weighted† 1990=100 Sep 17th	year ago	Currency units per $ Sep 17th	year ago	per £	per euro	per ¥100	Budget balance % of GDP 2003‡
Australia	− 11.8	Jul	− 24.4	Q2	− 5.1	− 4.6	83.1	73.6	1.51	1.83	2.41	1.69	1.29	0.2
Austria	+ 0.1	Jun	+ 1.0	Jul	+ 0.2	+ 0.1	103.1§	100.8	0.89	1.02	1.43	–	0.76	-1.3
Belgium	+ 18.7	May	+ 10.7	Mar	+ 4.7	+ 4.7	103.3§	100.0	0.89	1.02	1.43	–	0.76	nil
Britain	− 73.3	Jul	− 5.8	Q1	− 1.1	− 1.3	98.5	106.3	0.62	0.65	–	0.70	0.54	-1.9
Canada	+ 39.1	Jul	+ 14.7	Q2	+ 1.7	+ 1.6	85.5	75.0	1.37	1.59	2.19	1.54	1.18	1.1
Denmark	+ 9.5	Jul	+ 6.0	Jul	+ 2.6	+ 2.4	106.1	102.8	6.61	7.60	10.6	7.43	5.68	1.6
France	+ 5.7	Jul	+ 22.0	Jul	+ 1.4	+ 1.3	106.8§	102.9	0.89	1.02	1.43	–	0.76	-3.6
Germany	+135.1	Jul	+ 53.6	Jul	+ 2.0	+ 1.8	104.5§	99.8	0.89	1.02	1.43	–	0.76	-3.7
Italy	+ 2.1	Jun	− 16.6	Jun	− 0.5	− 0.4	76.1§	73.3	0.89	1.02	1.43	–	0.76	-2.4
Japan	+ 95.1	Jul	+115.9	Jul	+ 2.6	+ 2.8	132.1	133.6	116	121	187	131	–	-7.7
Netherlands	+ 30.3	Jul	+ 2.9	Q1	+ 2.2	+ 2.4	102.8§	99.0	0.89	1.02	1.43	–	0.76	-1.6
Spain	− 45.5	May	− 19.6	May	− 2.4	− 2.3	77.3§	75.0	0.89	1.02	1.43	–	0.76	-0.4
Sweden	+ 16.3	Jul	+ 11.1	Q2	+ 3.6	+ 3.4	81.0	77.6	8.06	9.32	12.9	9.06	6.93	0.7
Switzerland	+ 5.7	Aug	+ 32.7	Q1	+10.7	+10.6	110.7	114.1	1.38	1.50	2.22	1.55	1.19	na
United States	−535.6	Jul	−528.7	Q2	− 5.2	− 5.5	103.8	114.6	–	–	1.60	1.12	0.86	-4.6
Euro area	+ 80.4	Jun	+ 42.9	Jun	+ 0.6	+ 0.5	89.2	81.5	0.89	1.02	1.43	–	0.76	-2.5
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*													
Finland	+ 13.8	Jul	+ 10.2	Jul	na	na	82.2§	78.9	0.89	1.02	1.43	–	0.77	3.1
Greece	− 24.0	Jun	− 11.5	Jun	na	na	59.7§	58.0	0.89	1.02	1.43	–	0.77	-1.0
Iceland	nil	Jul	− 0.2	Q2	na	na	98.1**	89.0	79.3	88.3	127	89.1	68.2	nil
Ireland	+ 37.4	Jun	− 2.1	Q1	na	na	95.2§	89.3	0.89	1.02	1.43	–	0.77	-0.8
Luxembourg	− 3.3	Jun	+ 1.8	Q1	na	na	103.3§	100.0	0.89	1.02	1.43	–	0.77	0.2
New Zealand	− 1.6	Jul	− 1.4	Q1	na	na	99.0	86.6	1.71	2.13	2.74	1.92	1.47	0.8
Norway	+ 27.3	Aug	+ 26.5	Jun	na	na	96.7	105.6	7.29	7.51	11.7	8.19	6.27	11.3
Portugal	− 12.9	Jun	− 8.5	May	na	na	92.9**	90.0	0.89	1.02	1.43	–	0.77	-3.2

*Merchandise. Australia, Britain, France, Canada, Japan and United States imports fob, exports fob. All others cif/fob. †Bank of England except §IMF, June average. ‡OECD forecast. **IMF, April average.

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Corporate debt

Sep 18th 2003
From The Economist print edition

In 1997, corporate debt in Japan and America was nearly equal at $900 billion each. By 2002, however, total American corporate debt had risen to more than double that of Japan.

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Overview

Sep 18th 2003
From The Economist print edition

Brazil cut its benchmark interest rate by two percentage points to 20%.

Thailand's GDP growth slowed to 5.8% in the year to the second quarter.

Russia's GDP rose by 7.2% in the year to the second quarter.

Consumer-price inflation in **Poland** fell yet lower, to 0.7% in the year to August.

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Emerging stockmarkets

Sep 18th 2003
From The Economist print edition

Since the beginning of 2001, emerging stockmarkets have risen by about 11%, according to an index published by Morgan Stanley. Over the same period, America's S&P 500 index has suffered a decline of more than twice that size. Emerging markets have performed especially well since June. Among the emerging economies, China has seen the biggest increase in total market capitalisation over the past four years.

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Economy

Sep 18th 2003
From The Economist print edition

	% change on year ago						Latest 12 months, $bn				Foreign reserves* $bn, latest	
	GDP		Industrial production		Consumer prices		Trade balance		Current account			
China	+ 6.7	Q2	+17.1	Aug	+ 0.9	Aug	+21.4	Aug	+35.4	2002	356.5	Jul
Hong Kong	– 0.5	Q2	– 8.8	Q1	– 4.0	Jul	– 6.7	Jul	+18.4	Q1	111.8	Aug
India	+ 4.9	Q1	+ 5.6	Jul	+ 4.2	Jul	–12.3	Jul	+ 4.7	Q1	82.6	Aug
Indonesia	+ 3.8	Q2	+18.3	Mar	+ 6.4	Aug	+25.8	Jul	+ 6.7	Q1	32.3	Jul
Malaysia	+ 4.4	Q2	+ 4.6	Jul	+ 1.0	Aug	+17.0	Jul	+ 8.5	Q1	34.0	Jul
Philippines	+ 3.2	Q2	– 1.2	Jun	+ 3.0	Aug	– 0.7	Jun	+ 2.7	May	12.8	Aug
Singapore	– 4.2	Q2	– 6.3	Jul	+ 0.3	Jul	+13.7	Jul	+23.8	Q2	87.8	Aug
South Korea	+ 1.9	Q2	+ 0.7	Jul	+ 3.0	Aug	+ 9.9	Aug	+ 4.0	Jul	132.8	Jul
Taiwan	– 0.4	Q2	+ 7.5	Jul	– 0.6	Aug	+17.3	Aug	+26.9	Q2	185.7	Aug
Thailand	+ 5.8	Q2	+10.3	Jul	+ 2.2	Aug	+ 4.8	Jul	+ 8.9	Jul	36.7	Jul
Argentina	+ 5.1	Q1	+11.9	Jul	+ 4.9	Aug	+17.2	Jul	+10.1	Q1	13.6	Aug
Brazil	– 1.3	Q2	– 2.5	Jul	+15.1	Aug	+22.9	Aug	+ 2.6	Jul	47.3	Jul
Chile	+ 2.7	Q2	– 2.9	Jul	+ 2.9	Aug	+ 2.7	Aug	– 0.8	Q2	15.4	Jul
Colombia	+ 1.9	Q2	+ 1.0	Jun	+ 7.3	Aug	– 0.3	Jun	– 2.1	Q1	10.3	Aug
Mexico	+ 0.2	Q2	– 1.9	Jul	+ 4.0	Aug	– 6.5	Jul	–11.5	Q2	51.7	Jul
Peru	+ 3.3	Jul	+ 3.3	Jun	+ 1.9	Aug	+ 0.4	Jun	– 1.2	Q2	9.0	Aug
Venezuela	– 9.4	Q2	–11.4	Jun	+30.4	Aug	+14.6	Q2	+ 9.3	Q2	11.9	May
Egypt	+ 3.1	2002†	+ 4.2	2002†	+ 4.0	Jun	– 7.1	Mar	+ 1.0	Q1	13.4	Jun
Israel	– 0.3	Q2	– 0.8	Jun	– 1.1	Aug	– 6.3	Aug	+ 0.2	Q2	23.9	Aug
South Africa	+ 1.8	Q2	– 2.0	Jul	+ 5.2	Jul	+ 3.4	Jul	– 0.2	Q1	6.5	Jul
Turkey	+ 3.9	Q2	+11.9	Jul	+24.9	Aug	–18.1	Jun	– 4.1	Jun	28.7	Jul
Czech Republic	+ 2.2	Q1	+ 4.8	Jul	– 0.1	Aug	– 2.3	Jul	– 5.0	Q2	24.4	Aug
Hungary	+ 2.4	Q2	+ 6.1	Jul	+ 4.7	Aug	– 3.5	Jul	– 4.3	Jul	11.6	Aug
Poland	+ 3.8	Q2	+ 5.8	Aug	+ 0.7	Aug	–10.5	Jul	– 5.4	Jul	30.9	Jul
Russia	+ 7.2	Q2	+ 5.5	Aug	+13.3	Aug	+54.8	Jul	+36.4	Q2	59.0	Aug
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*											
Pakistan	+ 3.6	2002†	+15.8	Nov	+ 1.8	Aug	– 1.1	Aug	+ 0.6	Q2†	9.8	Jul
Saudi Arabia	+ 0.7	2002§	na		– 1.0	May	+38.6	2002§	+11.7	2002	21.3	Jun

*Excluding gold, except Singapore; IMF definition. †Year ending June. §Economist Intelligence Unit estimate.

Sources: National statistics offices, central banks and stock exchanges; Thomson Datastream; Economist Intelligence Unit; Reuters; J.P. Morgan Chase; Hong Kong Monetary Authority; Centre for Monitoring Indian Economy; FIEL; EFG-Hermes; Bank Leumi Le-Israel; Standard Bank Group; Akbank; Deutsche Bank

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Financial markets

Sep 18th 2003
From The Economist print edition

	Currency units			Interest rates	Stockmarkets	% change on		
	per $		per £	short-term	Sep 17th		Dec 31st 2002	
	Sep 17th	year ago	Sep 17th	% p.a.		one week	in local currency	in $ terms
China	8.28	8.27	13.3	na	1,456.7	−2.4	+ 2.6	+ 2.6
Hong Kong	7.80	7.80	12.5	1.09	11,140.1	+3.1	+ 19.5	+ 19.5
India	45.7	48.4	73.3	4.61	4,235.4	−4.5	+ 25.4	+ 31.6
Indonesia	8,425	9,000	13,511	9.00	585.9	+2.3	+ 37.9	+ 46.5
Malaysia	3.80	3.80	6.09	3.10	747.0	+1.5	+ 15.6	+ 15.6
Philippines	54.9	52.3	88.1	7.63	1,320.6	+2.2	+ 29.7	+ 26.0
Singapore	1.75	1.77	2.81	0.81	1,602.8	+2.3	+ 19.5	+ 18.4
South Korea	1,170	1,208	1,876	3.81	766.6	−0.1	+ 22.2	+ 23.8
Taiwan	34.1	34.6	54.6	1.15	5,747.1	+2.2	+ 29.1	+ 31.8
Thailand	40.4	42.9	64.8	1.29	558.7	−0.3	+ 56.7	+ 67.2
Argentina	2.93	3.63	4.70	7.13	800.0	+4.9	+ 52.4	+ 74.8
Brazil	2.91	3.35	4.66	21.84	16,492.4	+3.2	+ 46.4	+ 78.2
Chile	681	730	1,092	2.76	6,791.6	+0.4	+ 35.3	+ 43.1
Colombia	2,823	2,788	4,527	7.79	2,162.8	+0.9	+ 34.4	+ 36.6
Mexico	10.94	10.02	17.6	4.77	7,746.5	+0.2	+ 26.4	+ 20.9
Peru	3.48	3.60	5.58	2.77	1,944.7	+0.3	+ 39.7	+ 41.1
Venezuela	1,598	1,450	2,563	16.68	17,829.5	+15.2	+122.4	+ 93.0
Egypt	6.15	4.64	9.85	8.00	9,624.6	+3.8	+ 79.2	+ 35.0
Israel	4.48	4.79	7.18	3.55	419.7	+0.7	+ 26.2	+ 34.0
South Africa	7.4	10.6	11.8	9.60	9,417.6	−0.4	+ 1.5	+ 18.0
Turkey	1,388,000	1,667,750	2,225,936	31.00	12,958.2	+5.2	+ 25.0	+ 49.4
Czech Republic	29.3	31.0	47.0	2.06	647.8	+2.4	+ 40.6	+ 44.3
Hungary	229	249	367	9.44	9,316.9	+1.7	+ 19.5	+ 17.5
Poland	3.97	4.16	6.37	5.14	20,223.6	+1.2	+ 40.8	+ 36.0
Russia	30.6	31.7	49.2	16.00	550.9‡	+2.4	+ 47.2	+ 53.4
EMF (MSCI)*	1.00	1.00	1.60	na	384.8	+0.3	na	+ 31.7
EMBI+†	1.00	1.00	1.60	na	278.8	+0.7	na	+ 21.8

*Emerging Mkts Free. †J.P. Morgan Chase's Emerging Mkts Bond Index Plus. ‡ In $ terms.

Sources: National statistics offices, central banks and stock exchanges; Thomson Datastream; Economist Intelligence Unit; Reuters; J.P. Morgan Chase; Hong Kong Monetary Authority; Centre for Monitoring Indian Economy; FIEL; EFG-Hermes; Bank Leumi Le-Israel; Standard Bank Group; Akbank; Deutsche Bank

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